# SUBMISSIONS TO THE ROYAL COMMISSION ON BANKING AND FINANCE

THE CANADIAN BANKERS' ASSOCIATION

NEIL J. McKINNON, PRESIDENT,
CANADIAN IMPERIAL BANK OF COMMERCE

G. ARNOLD HART, PRESIDENT,
BANK OF MONTREAL

W. EARLE McLAUGHLIN, CHAIRMAN AND PRESIDENT,
THE ROYAL BANK OF CANADA



SUPPLEMENT TO THE CANADIAN BANKER • SPRING 1963

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# ROYAL COMMISSION ON BANKING AND FINANCE

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W. Thomas Brown, M.B.E., Investment Dealer, Vancouver, British Columbia

James Douglas Gibson, O.B.E., Banker, Toronto, Ontario

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# SUBMISSION OF
# THE CANADIAN BANKERS' ASSOCIATION

Filed July 1962—Appearances January 1963

# THE CANADIAN BANKERS' ASSOCIATION

The Canadian Bankers' Association is the association of the eight Canadian banks chartered under the Bank Act. Its Executive Council is composed of the general managers of these banks. The members of the Council at the time of filing this brief, and their offices in the Association, were as follows:

**President**
R. D. Mulholland, Bank of Montreal.

**Vice-Presidents**
J. P. R. Wadsworth, Canadian Imperial Bank of Commerce
Léo Lavoie, The Provincial Bank of Canada.
J. D. Gibson, The Bank of Nova Scotia.
C. B. Neapole, The Royal Bank of Canada.

**Members of Council**
A. E. Hall, The Toronto-Dominion Bank.
Louis Hébert, Banque Canadienne Nationale.
D. C. Langford, The Mercantile Bank of Canada.

**Appearances**
Hearings at Ottawa, Ontario, January 15, 16 and 17, 1963.

**R. D. Mulholland**
Vice-President and General Manager, Bank of Montreal;
President, The Canadian Bankers' Association.

**T. A. Boyles**
Deputy General Manager, The Bank of Nova Scotia.

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General Manager, The Toronto-Dominion Bank.

**Lorenzo Hébert**
Assistant General Manager, The Provincial Bank of Canada.

**J. P. R. Wadsworth**
Vice-President and General Manager, Canadian Imperial Bank of Commerce.

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General Manager, The Royal Bank of Canada.

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General Manager, Banque Canadienne Nationale.

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**J. V. M. Chambers**
Secretary to the Committee.
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**H. H. Whipp**
Chief Accountant, Canadian Imperial Bank of Commerce.

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# INTRODUCTION

In recent years there has been considerable progress in understanding the role of finance in modern society. It is the hope of the Canadian chartered banks that the facts and opinions set out in this brief will help the Royal Commission on Banking and Finance in its enquiry into these matters, to the benefit of Canada as a whole.

Much of the statistical and explanatory material in the pages which follow has been compiled on the basis of experience with questions that are likely to be asked during Bank Act revision proceedings and similar enquiries. However, it should be pointed out that part of the material has been included in answer to detailed and searching questions asked by the staff of the Commission itself, in the course of discussions with representatives of The Canadian Bankers' Association. The chartered banks welcomed these enquiries and have endeavoured to deal fully with the important issues raised.

Nevertheless this brief does not pretend to offer definitive answers to all the questions it raises, because these matters carry well into areas where value judgments must be made between alternative objectives and where it would be neither possible nor desirable for the chartered banks as a whole to speak with one voice. Accordingly they have presented a common viewpoint wherever possible, and where specific recommendations are made such recommendations carry the support of the banks generally. On the other hand where there has been a division of opinion on substantial matters the brief acknowledges it and endeavours to summarize the major viewpoints.

# PART ONE

# THE ROLE OF FINANCIAL ORGANIZATIONS

## SECTION I

## POLICY OBJECTIVES AND INSTRUMENTS

### The Objectives of Monetary Policy

1. The preamble to the Bank of Canada Act reads:

> Whereas it is desirable to establish a central bank in Canada to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion . . .

Although written over a quarter of a century ago, this statement is still remarkably apt. Perhaps the only major change needed to reflect current thought would be an explicit reference to the objective of sustained economic growth.

2. Reporting in 1959, the Radcliffe Committee in the United Kingdom listed as objectives in pursuit of which monetary policy might be used:

> (1) A high and stable level of employment.
> (2) Reasonable stability of the internal purchasing power of money.
> (3) Steady economic growth and improvement of the standard of living.
> (4) Some contribution, implying a margin in the balance of payments, to the economic development of the outside world.
> (5) A strengthening of London's international reserves, implying further margin in the balance of payments.[1]

3. Two years later the Commission on Money and Credit in the United States, under the heading "National Economic Goals," stated that:

> An adequate rate of economic growth, sustained high levels of production and employment, and reasonable stability of prices are clearly the three objectives of central concern for monetary, credit, and fiscal policies. These three goals, however, must be sought in the context of other important national objectives . . . [including] national security . . . harmonious international economic relations and contributions to economic development abroad . . . economic freedom . . . [and] an equitable distribution of opportunity and income . . . [2]

4. Both these reports point out that the attainment of the various goals may interfere with one another. The U.S. report states that "no single economic goal can be wholly unqualified, because each may have to be sought subject to constraints imposed by other goals or at costs representing sacrifices, to some degree, of other goals."[3] The Radcliffe report follows up its list of objectives with this paragraph:

> In listing these five objectives, we have to acknowledge that there are serious possibilities of conflict between them. The choice between them, where choice has to be made, is one that Governments have to face. The freedom of Governments in making these choices is not absolute. It is limited by the importance of each of these objectives to the continuous and orderly life of society. The immoderate pursuit of one or several of these ends at the expense of another may place an intolerable strain on the body politic. To pursue the other desirable objectives, cost what it may in terms of unemployment, or to sacrifice all reasonable stability of the value of money in an attempt to realise the remaining objectives, are examples of the ways in which society could be disrupted.[4]

[1] United Kingdom, Committee on the Working of the Monetary System, *Report* (London, Her Majesty's Stationery Office, Cmnd. 827, 1959), para. 69.

[2] *Money and Credit*, the Report of the Commission on Money and Credit (Prentice-Hall Inc., Englewood Cliffs, N.J., 1961), pp. 9-10.

[3] *Ibid*, p. 10.

[4] *Op. cit.*, para. 70.

5. These descriptions of economic objectives are remarkably parallel. In summary, it may be said that the most generally accepted goals are full employment, stable domestic prices, healthy economic growth, and a sound and dependable relationship between the domestic economy and the world economy of which it is a part. In pursuance of these objectives it may be taken as a general principle that the methods used should be those of the normal price and market mechanism as far as possible, or at least should be compatible with the effective operation of that mechanism.

**Monetary and Fiscal Policies**

6. Monetary policy and fiscal policy are generally thought of as the two main instruments available to the authorities for pursuing the major economic objectives described above. When properly used they are compatible with the price and market mechanism; indeed, smoothly operating financial markets are important to the optimum effectiveness of both monetary policy and fiscal policy.

7. Monetary policy may be defined as the use of central banking techniques to influence the general level of business activity. The aspect of it that is most familiar is central bank control over the level of the chartered banks' deposit obligations, which constitute the main part of the money supply. Of course control of bank deposits also means control of the total volume of the loans and investments of the banks.

8. The essence of fiscal policy is the management of the total amount of government revenues, the total amount of government expenditures, and the difference between them, as a device for regulating the pace of business activity.

9. Monetary policy decisions and fiscal policy decisions, separately or in combination, should be framed so as to balance investment demand with the flow of savings the community generates when operating at full capacity. The flow of goods and services through the production lines to the ultimate consumer is controlled and directed by the flow of money payment in the opposite direction (the spending stream), and the income of individuals and businesses is generated as part of the spending stream that keeps the production lines moving. The point at which the community's saving and investment decisions are brought together is particularly vulnerable. These decisions are made by quite different groups of people, and for different reasons, yet some way must be found to keep the decisions in balance, otherwise the smooth flow of the spending stream will be interrupted. If the demand for borrowed funds (say, to invest in new productive enterprises) is greater than the rate at which the community tends to save at a given level of income, expansionary forces will be generated; if the rate of saving tends to exceed the demand for borrowed funds, there will be contractionary forces.

10. Monetary policy operates basically by influencing private decisions to invest or to save. It does so primarily by altering the size of the cash base of the economy, but also to some extent by making it easier and cheaper to borrow, if investment needs stimulating, or by making it dearer and more difficult to borrow, if investment needs to be restrained. It should be noted, however, that the interest differential tends to press more heavily on social capital borrowing than on borrowing for commercial purposes, in part because of the impact of the corporate income tax. Changes in interest rates are supposed to encourage saving and low interest rates to discourage saving, though there is some dispute about how effective this influence is.

11. Fiscal policy, on the other hand, operates by using a budgetary deficit as a substitute for private investment, or a budgetary surplus as a supplement to private saving. As we know it today fiscal policy may be said to have originated as an aid to monetary policy, because in the 1930's easy money and low interest rates alone had proven inadequate to stimulate recovery. For a while, however, it seemed to have completely swallowed up monetary policy. In the 1950's monetary policy staged a more or

less world-wide revival, but probably we have yet to see the optimum use of the two techniques working as a team rather than as alternatives.

**Limitations of Monetary and Fiscal Policies**

12. One of the most obvious limitations of monetary policy, already referred to, is that it may fail to stimulate investment sufficiently in times of serious recession. The interest rate that the investor would have to pay for borrowed funds is not the only factor involved in a decision to invest, and may not be a significant factor if there is any doubt about the profit possibilities of the investment. Thus monetary policy is permissive rather than decisive in such circumstances; it can be effective in restraining an inflationary boom, but it may fail to stimulate expansion from a depressed economic position.

13. One of the great virtues of monetary and fiscal policies is that they tend to be general in their incidence. That is to say they operate on the total spending in the economy, without any marked effect on particular sectors, and they offer a minimum of interference with normal market forces. But this very virtue implies a corresponding limitation, namely that they may be blunt and imprecise. They cannot be used to give selective stimulus or restraint to a particular region or sector of the economy.

14. As stimulants to expansion, monetary and fiscal policies can often be effective when the problem is one of re-employing people who have been thrown out of work by a short-term recession. In this circumstance there are productive units ready to resume operations, skilled operatives ready and willing to get the production lines going, and so on. The major requirement is to get money flowing back into the hands of consumers; they are likely to spend it, and that is enough to get the wheels of industry rolling faster again.

15. Monetary and fiscal policies by themselves can do much less to expand production into new and untried fields, even if there are substantial reserves of unemployed labour and potential productive capacity. This can be clearly seen for example in many of the developing countries today, but it also occurs to some extent here in Canada in relation to efforts to expand production beyond previous levels or into new lines. Such expansion requires initiative, capital, management, new labour skills, perhaps new skills in finance and marketing and various other fields, as well as access to raw materials; and all of these requirements must be brought together in the form of actual going concerns of economically efficient size. Suitable monetary and fiscal policies can do much to promote a favourable climate for developments of this kind, but they are not sufficient by themselves to overcome the various problems involved.

16. However, there is another major limitation on monetary and fiscal policies, and this applies to the already developed countries as well as the developing countries. It is rooted in the fact that any national economy is part of a world economy in which international trade is extensive and pervasive. International trade confers major benefits in a great many ways, for the international division of labour is one of the foundation stones of the high standard of living the western world has achieved. Nevertheless it does inevitably make each country dependent to a considerable extent on conditions in other countries, and limits the independence of domestic policies in important ways. It means, for example, that a part of the Canadian spending stream is directed abroad, and a part of Canadian income originates in spending by foreigners on Canadian exports. This complicates the application of monetary and fiscal policies in two ways: (1) it introduces a new possibility of imbalance in the spending stream, in that income originating abroad may not be in balance with income spent abroad; and (2) unlike saving and investment decisions, foreign spending on Canadian products cannot be directly influenced by the level of domestic incomes or liquidity.

17. Foreign trade has important implications for national monetary and fiscal policies. The international division of labour means that the domestic price structure must be kept in line with the price structure in other parts of the world. This is particularly clear for the prices of internationally traded goods such as wheat, newsprint, and base metals, which are of major importance to Canada. However, the same is largely true even for domestic goods that do not cross any international boundaries in search of markets, partly because of the competition from imported goods, but also because wages and other costs in domestic industries are influenced by wages and costs in export industries owing to the mobility of labour and other resources. The result is that an expansionary monetary and fiscal policy will be less effective when domestic costs are out of line, because a substantial portion of the increase in spending will be channeled into imported goods and will not add directly to domestic income.

18. It may be noted that the interest rate structure must be considered as part of the price structure from this point of view. The interest rate is the price that must be paid for the use of someone else's capital, and capital is one of the most international of international commodities. Assuming equal economic and political stability, domestic interest rates cannot get very far out of line with interest rates in other countries without causing capital movements that may force a change in domestic policies. For example, an easy-money policy in one country during a recession might reduce interest rates so far below those prevailing in other countries that it would cause an out-flow of funds and either drain exchange reserves or unduly depress the exchange rate. Or a tight-money policy designed to combat domestic inflationary pressures might raise interest rates enough to attract unwanted funds from abroad, which would reinforce the inflationary pressures or threaten an appreciation of the exchange rate.

### Other Policy Instruments

19. It is quite possible that there is too much concentration on monetary and fiscal policies, as if they were the only means of promoting the desirable economic objectives discussed earlier. In point of fact there is a wide range of additional measures that can be employed to good effect, for example, public debt management, taxation policy, commercial, tariff and exchange rate policies, and measures to encourage increased productivity. However, this brief must be concerned primarily with monetary matters.

# SECTION II

## THE FINANCIAL ORGANIZATION OF THE CANADIAN ECONOMY

### The Role of Finance

20. The financial system plays a complex and essential role in the modern economy. It provides the means of payment, in the form of bank notes or deposits subject to chequing, through which the price and market system works. It offers a means of remitting funds or collecting funds from distant places, either within the country or abroad. To the saver it offers a wide choice of outlets for the employment of accumulated savings and facilities for keeping them safe from loss or theft. To the creditworthy borrower it offers a wide range of sources of funds, from which he can normally expect to make whatever arrangements will best suit his needs. It also offers still other services such as insurance, estate management, and so on.

21. Another major function of the financial system is to mediate between those who do not wish or are not able to invest their savings directly in physical assets and those who draw on the savings of others to supplement their own resources. A substantial

portion of this mediation takes place through the arrangement of loans or the purchase and sale of securities between principals, either in direct negotiation or in transactions through investment dealers and brokers on organized or over-the-counter markets; it may involve the issue of new securities or loan contracts or other types of financial claims, or trade in existing claims. Another major portion takes place through various financial institutions, such as banks, trust companies, mortgage loan companies, credit unions, insurance companies, finance companies, small loan companies, factoring companies, and others, which receive funds from one group and lend to another and accordingly may be described as financial intermediaries.

22. The importance of effective financial organization is implicit in the need to maintain a balance between the community's investment demands and the flow of savings it tends to generate when all its resources are fully employed, as explained in Section I. Any tendency to imbalance in this relationship will make itself felt in financial terms, and so must any measures taken to correct such a tendency. Both monetary and fiscal policies operate by influencing one side or the other of this relationship as reflected in the supply of and the demand for financial claims. Sound and responsive financial institutions and financial markets are thus essential to the use of these policies for promoting Canada's major economic objectives.

23. Until fairly recent years it was generally held that banks were categorically different from other financial institutions in that the former could "create" credit whereas the latter could only re-lend funds entrusted to them. Even today there are those who maintain this position. However, an increasing number of economists now hold the view that credit "creation" is not peculiar to the banking system, but occurs in basically the same form in various parts of the financial structure. The emphasis is placed on the general liquidity of the economy, not on the quantity of money alone. It is argued that the total resources available to the capital market and to all financial institutions combined is determined by the laying aside of financial savings out of income, and that the allocation of these resources to banks and to other financial institutions is determined by the free choice of savers in deciding how to employ their savings. The distinction between banks and other financial institutions lies not in any mysteriously different source of resources but in the ready acceptability of bank deposits by spenders and savers alike; bank deposits are a particularly attractive form of liquid asset because they are a means of payment and hence are useful not only as a savings vehicle (liquidity motive) but also as working balances (transactions motive).

24. It is of course technically true that the Canadian banking system can expand its assets (in the form of loans and investments) and its liabilities (in the form of deposits) but only within limits fixed by the amount of cash reserves the Bank of Canada allows them. However, the banks themselves cannot determine these limits. It is entirely up to the national monetary authorities to decide what level of bank deposits is appropriate.

25. It is unnecessary to attempt to resolve these theoretical arguments here, however, important though they may be in themselves; the reason for raising them is primarily to indicate the complexities of using monetary and fiscal policies for the promotion of the major economic goals described in Section I. The object of the authorities in using these policies must be to maintain a balance between the economy's investment demands and its rate of saving at optimum levels of income, taking account of the limitations of these policies themselves. This means maintaining the smooth flow of the spending stream as a whole. From this point of view it makes no difference whether a loan-financed expenditure is made possible by the expansion of the money supply (quantity of money) or by more intensive use of the existing money supply (velocity of circulation), for both affect the spending stream. It is clear, therefore, that the authorities should be concerned with all forms of credit, including that granted by other financial inter-

mediaries as well as by banks and including that obtained through the money and capital markets.

26. The type of lending business carried on by the various financial intermediaries should not be determined by arbitrary rules, but should be left to the play of market forces and natural specialization. Institutions with long-term contracts predominating among their liabilities, such as life insurance companies and pension funds, may be expected to seek relatively long-term outlets for their funds, including bonds and mortgages, though of course they will need some shorter-term and therefore more liquid assets as well in order to allow for unexpected variations in their cash flows. Institutions that are designed to provide specialized forms of credit, on the other hand, such as finance and factoring companies, etc., may try to raise funds through contracts with maturities more or less comparable to their loan contracts. In general, however, there is no compelling reason for having precisely matching maturities in the borrowing and lending contracts of the same institution, provided a liquid reserve is maintained that is adequate to the risks involved and provided the asset "mix" is appropriate to the fundamental nature of the business.

27. In the case of banks it was formerly thought necessary that they should confine their loans and investments to short-dated maturities, because their obligations are usually repayable on demand. Nowadays, however, it is recognized that it is feasible for them to put a limited portion of their funds into longer-dated loans and investments. Nevertheless, it remains true that the first priority in bank lending must still be given to short-term business borrowing for working capital purposes, because the banking system in Canada, as in most other parts of the world, developed in response to these needs and there appears to be no other source similarly qualified to provide, administer and supervise this type of loan.

### The Role of the Banking System

28. Banks are clearly financial intermediaries, and clearly have a special role to play in the functioning of the financial system. However, while "a bank" in popular understanding is a specific and readily identifiable type of institution, it is not easy to find a satisfactory definition—a problem that is by no means peculiar to Canada. The Bank Act gets around the difficulty by defining a bank as "a bank to which this Act applies" (sec. 2), i.e. "each bank enumerated in Schedule A (sec. 4)," but that leaves the real question unanswered.

29. One possibility would be to define a bank by describing its activities. Among its essential features are that it accepts deposits repayable on demand or short notice, some or all of which are normally transferable by cheque,[1] and lends or invests the funds deposited with it. Other services which are normally performed by banks and which are commonly thought of in Canada as typical banking functions include foreign exchange transactions, buying and selling domestic or foreign bills of exchange, the collection of clean or documentary bills, remittances, cheque clearing, issuing letters of credit, giving financial guarantees, safekeeping of securities or other valuables, rental of safety deposit boxes, and so on. However, there is hardly a single one of these services that is not offered to the Canadian public by some financial institution other than a chartered bank.

30. Another possibility would be to define a bank as an institution having liabilities that are generally acceptable for making and receiving payments, such as bank notes or chequing deposits. This is what distinguishes "money" from "near money" in most theoretical treatments, and there is some logic in identifying the money-providing function with banking.

[1] Canadian law defines a cheque as a bill of exchange drawn on a bank and payable on demand. In common usage, however, the term is used to include similar bills drawn on other financial institutions.

31. However, it seems impossible to define banking in a way that meets universal acceptance. In what follows, unless otherwise indicated by the context, the word "bank" will be synonymous with "chartered bank" and will be used in the sense in which it is defined in the Bank Act.

32. Just as one of the recognized key functions of a central bank is that of lender of last resort for the commercial banking system, so the commercial banks in turn perform a similar function for other financial intermediaries, though this is probably less well understood. These institutions typically carry working balances with the banks, just as other businesses do. They also customarily maintain lines of credit with their banks, whereby they are able to borrow on short notice within agreed limits. In this way they are able to operate with minimum working balances and yet with reasonable assurance of being able to meet any unexpected demand for funds. The liquidity of the entire financial structure thus depends largely on the liquidity of the banks.

33. Modern views of the respective roles of banks and other institutions within the financial structure differ substantially from those of even a generation ago, and indeed one of the most important tasks before the Royal Commission may be that of putting these relationships in better perspective. Without trespassing on the ultimate findings of the Commission in this respect, however, it may be said that the present-day questioning of older ideas in this field does not detract from the key role of the banking system in maintaining a balance between the saving and investment decisions of the community. When business is slack the almost universal acceptability of bank deposits by savers and lenders alike assures the community of whatever degree of liquidity may be necessary to sustain business operations. In times of inflationary boom the dependence of a community on money as the means of effecting transactions offers the authorities a powerful and flexible weapon for keeping the volume of spending in line with the physical volume of goods and services becoming available.

34. For their part Canadian banks from earliest days have recognized the need to co-operate with official financial policies in the public interest. They recognize this need no less now, because of the key position of the banking system in carrying out such policies and promoting economic stability.

**Criteria of Performance**

35. Determining whether the financial system is performing adequately or otherwise at any given point of time must necessarily involve subjective judgments to a substantial extent. It is particularly difficult at times to distinguish shortcomings that are attributable to the system itself from those that are attributable to particular policies being pursued by the authorities or by major public or private institutions. What has so far been said about the role of finance does suggest some reasonably objective criteria, however, which should at least be helpful in forming such judgments.

36. One useful criterion is the success of official policies in achieving the major economic goals listed in Section I. If these goals are being reached reasonably successfully, there is a *prima facie* case for supposing that the financial system must also be working fairly well; if not, then the financial system should certainly be examined, along with other aspects of the economy, to see if any improvements can be made.

37. Whether the economy as a whole is working well or ill, however, there are certain minimum standards that should be met by the financial system. The supply and demand for funds in each of the various sectors of the money and capital markets should be kept in balance fairly smoothly, without sharp fluctuations in security yields or interest rates. The differential between the rates in various markets should be reasonable in the light of the underlying differences in the nature of the contracts involved, including differences in costs of administration or supervision, differences in maturity, and differences in risk. Differential advantages or disadvantages for certain classes of borrow-

ers or lenders, or for the financial institutions through which they customarily obtain or employ their funds, should not be permitted to occur unless clearly necessary in the public interest. Further, the policies of all types of financial institutions should be in harmony with the public interest, even if that requires some sacrifice of their particular interests; the financial system must clearly serve the public, not the other way round.

**38.** Finally, and with particular respect to the role of banking in the economy, it is submitted that the public interest is served by the existence of a strong banking system. A bank is more than a repository of deposits on the one hand, and a medium for making loans and investments on the other. The fact that the deposits entrusted to the chartered banks are the banks' liabilities to the public is an accounting truism, but its real significance tends to be overlooked or taken for granted. Not since 1923 has there been a bank failure in Canada. Thus, for a generation, no Canadian has lost a night's sleep worrying about the safety of his "money in the bank." Indeed, the Canadian banking system enjoys a world-wide reputation for soundness and stability, and this in itself has been a factor of no small significance in the nation's economic development.

# PART TWO

# THE OPERATIONS OF THE CHARTERED BANKS

## SECTION I

## RESERVES

### Reserves

**39.** Each chartered bank is required by s. 71(1) of the Bank Act to "maintain a cash reserve in the form of a deposit with the Bank of Canada and of Bank of Canada notes held by the bank, and such reserve shall be not less on the average during any month than eight per cent, or such other percentage as may be fixed by the Bank of Canada under the provisions of the Bank of Canada Act, of such of its deposit liabilities as are payable in Canadian currency." These requirements are an average for the month, and at any moment of time within the month a bank may have either more or less than enough cash to meet its legal requirements.

**40.** In November 1955 the chartered banks acceded to a request by the Governor of the Bank of Canada that in addition to the prescribed cash reserve each bank would hold day-to-day loans and Government of Canada Treasury bills in such amounts that the total of cash, day loans, and bills would average not less than 15 per cent of deposit liabilities throughout each month, effective in June 1956.

### Management of the Cash Position

**41.** Management of the cash position of a chartered bank is a matter of keeping the cash on hand adjusted to the cash needs and wants of the bank. In deciding how much cash it should be holding at any moment of time, a bank will be influenced by the number of business days left in the month, by the state of the money market, and by any cash gains or losses anticipated before the end of the month. For example, if a new month has just started, if there are limited opportunities for acquiring money-market assets at profitable rates, and if large cash losses are expected to occur later in the month, a bank may well be content to hold for the time being more cash than it needs to meet its legal requirements. Conversely, if cash gains are expected to occur later in the month, a bank may be satisfied to hold for a short time rather less cash than would otherwise be the case. Considerations such as these, as well as legal requirements, thus determine the amount of cash a bank will want to hold at any given moment.

**42.** It is a head office function to see that the cash on hand is kept adjusted to the current cash objectives of the bank. If the cash on hand exceeds minimum foreseeable requirements in relation to the objective, the bank will immediately try to invest the excess. If the cash on hand falls short of the objective, the bank will try to raise, as cheaply as possible, the cash necessary to make good the deficiency. In this way the bank tries to avoid holding more cash than it has to or to avoid letting its cash fall below its objective. In short, cash management in a chartered bank is the art of trying to keep the amount on hand adjusted to the objective of the bank day by day throughout each month.

**43.** The task is a complicated one, for the cash a bank can count on having is affected by many variables or unknowns. Each business day a bank makes the first computation of its cash position around 10 a.m., after getting the results of the Montreal and Toronto clearings. At this time it does not know for sure how its cash will be affected by such things as the clearings in Western Canada, the results of which come

in later during the day, or by currency shipments taking place between its branches and the Bank of Canada that day. Yet if the bank wishes to make an adjustment in its cash position that day it is more or less compelled to act on the basis of the early morning figure. Cash management must also take into consideration known or anticipated changes in large accounts, the volume and timing of the foreign-exchange transactions that the bank has to carry out, and the state of activity in the money market. All these elements add to the difficulty of ascertaining the exact amount of cash firmly held by the bank and the extent to which cash losses or gains are temporary or permanent.

44. Once a bank concludes that it has too much or too little cash, it acts as fast as it can to remedy the situation. To do so it must deal in assets that can be easily purchased or sold for cash in substantial volume. In Canada these properties are normally possessed by day-to-day loans to money-market dealers, by Treasury bills, and by short-term Government of Canada securities. By using these assets, in lieu of trying to find buyers or sellers for less actively traded assets, a bank can usually keep its cash supplies adjusted to its cash needs smoothly and rapidly. However, the extent to which a bank can reduce its holdings of Treasury bills and day-to-day loans is limited by the undertaking to meet the 15 per cent liquid asset ratio. In case of need the banks may borrow temporarily from the Bank of Canada while making more permanent adjustments.

45. If a bank finds it is continually accumulating liquid assets after accommodating current loan demands, it will at some stage begin to switch out of the liquid assets into less liquid ones seeking more profitable uses for its funds. In the opposite case, where it is continually disposing of liquid assets to meet daily cash deficiencies, the bank will be forced sooner or later to dispose of less liquid assets, either to raise cash or to restore holdings of liquid assets, and eventually it will have to adopt a more restrictive lending policy.

46. How quickly a basic trend in the cash position of a bank influences its investment and lending policies depends on the stock of liquid assets held by the bank, the rate at which the stock is changing, and the view of the bank of the intentions of the central bank. If a bank knows that it is the intention of the central bank to maintain a given degree of pressure or restraint in the current economic environment, it will move much faster to adjust its investment and lending policies than it will if it is uncertain about central-bank intentions. In the end the timing of the ultimate response to a basic change in the cash position of a bank depends to a very large extent on the bank having a clear understanding of central-bank intentions.

### The Present Method of Calculating Cash-Reserve Requirements

47. From the point of view of the chartered banks it is desirable that legal cash-reserve requirements be specified in a way that does not add to the uncertainties and difficulties in managing their cash positions. In terms of these criteria the present method of setting the requirements is satisfactory.

48. The formula for determining the amount of the cash reserve required to be maintained by a bank during any month is contained in s. 71 (2) of the Bank Act:

> 71 (2) For the purpose of determining the amount of the cash reserve required to be maintained by a bank during any month
>
> (a) the amount of its deposit liabilities payable in Canadian currency shall be the average of such deposit liabilities at the close of business on Wednesdays in each of the four consecutive weeks ending with the last Wednesday but one in the preceding month,
>
> (b) the amount of Bank of Canada notes held by the bank shall be the average holdings of such notes at the close of business on Wednesdays in each of the four consecutive weeks ending with the last Wednesday but one in the preceding month, and
>
> (c) the amount of its deposit with the Bank of Canada shall be the average amount of such deposit at the close of business on each juridical day of the current month.

Thus each chartered bank's reserve requirement for each month is based on figures for

a previous period and is therefore known in advance.

49. The present method of fixing the reserve requirements in advance for the next reserve period has been criticized on a number of grounds. It has been pointed out that changes in the reserve base, and so in requirements, may at times be quite abrupt, requiring similarly abrupt intervention by the central bank if it wishes to maintain the same degree of ease or tightness of reserves. Such abrupt changes might also affect the money market by causing unrealistic swings in interest rates which could be misinterpreted. It is contended as well that the present method does not cause requirements to change fast enough when all banks are expanding simultaneously. In any one month the banks could expand in step and would face no restraint from a rise in requirements until the following month. It is asserted that tying bank reserve requirements to the latest deposit figures would make monetary policy more effective because any increase in deposits would bring an immediate deficiency in the cash position, and the banks would react as if the central bank had taken cash away from them. We do not agree with these assertions.

50. As the requirements stand at present the central bank can readily counter any unwanted expansion or contraction almost immediately by open-market sales or purchases of securities. If for example there is an expansion because the banks are adding to their holdings of marketable securities the central bank could offset it by selling securities. If on the other hand the banks are adding to their loans the effects will not show up in the open market, at least not immediately, but in the deposit liabilities of the banking system. If the central bank sees deposits rising when it would prefer them not to rise, it can withdraw cash from the banking system to counter the expansion.

51. Whether an automatic change in the cash position, caused by a rise in requirements, is to be preferred over a discretionary cash change, produced by the central bank selling securities when it sees bank deposits rising, depends primarily on whether the automatic cash change would occur faster than the discretionary change. If the central bank did not receive deposit figures until much later than do the individual chartered banks, there would clearly be merit in favouring automatic cash changes. Under Canadian conditions however deposit figures are available to the central bank almost as soon as they are to the individual chartered banks.

52. Another criticism of the present formula for setting reserve requirements is the length of the averaging period, i.e. a calendar month, which is alleged to cause the banks to be sluggish in response to their daily cash position. Rapidity of response, however, also depends on the instruments available for adjusting bank cash and on the volume of transactions that the market in those instruments can handle. The shorter the reserve period the better the market has to be and the greater the variety of instruments required. A shorter period would make it more difficult for a bank to carry out its cash adjustment transactions in the money market. On the selling side it would have to bunch its transactions more, and on the buying side it might have to forego some transactions because of limitations in the market. In other words, shortening the reserve period does not necessarily lead to faster responses.

53. If the averaging period were shortened, however, the present restrictions on chartered bank borrowing from the Bank of Canada should be eased, and indeed these restrictions merit review in any case. It is now the practice for the Bank of Canada to make advances against the hypothecation of suitable securities, and advances to each bank are normally limited to a specified amount somewhat resembling an established line of credit; these limits have not been changed in many years notwithstanding the substantial increase in banks' assets and liabilities. Each advance or renewal of an advance is made for a fixed period of seven days. The first advance in any calendar month up to the specified amount bears interest at the Bank Rate. However, a second advance to the same bank in any calendar month, or a renewal of an advance, or an advance in excess

of the specified amount, bears interest at some unspecified higher rate and is subject to negotiation. These limitations interfere with the traditional role of the central bank as lender of last resort.

54. Moreover, a "Bank of Canada Funds" market would probably be a prerequisite for overcoming the difficulties that would ensue. A "Bank of Canada Funds" market, in which banks could sell their excess cash with the Bank of Canada to banks in need of cash, could be introduced, as in the New York money market where there is active trading in "Federal Funds." Whether such a market should be introduced even under the present method of calculating reserve requirements depends on the ultimate effect it would have on the money market. We are not opposed to such an innovation, but we believe that it would inhibit the development of the money market.

55. On balance we consider the advantages of fixing the cash reserve requirement in advance and averaging reserves over a calendar month outweigh the disadvantages. We recognize that in the public interest bank credit policies must conform to the requirements of monetary policy with reasonable promptness, but we feel that any proposed change should be clearly justified in advance, especially if it would add to the burdens that are imposed on the chartered banks and only on the chartered banks.

56. Another aspect of the present arrangements for cash requirements that the Commission may wish to consider is the minimum level of eight per cent for the legal reserve ratio. The rapid growth of financial institutions outside the banking system makes this a particularly relevant question. Too high a reserve ratio puts the banks at a cost disadvantage compared with these other institutions which are not hindered by legal-reserve requirements in bidding for business. A smaller ratio would not impede monetary control and would contribute to a more competitive financial system.

57. The size of the ratio is of some significance to monetary policy as well. The central bank presumably reacts to the sum total of economic activity, including financial activity inside and outside the banking system, in pursuing both its short-run and its long-run objectives for the economy. Accordingly, any growth in near-bank financial institutions appears to be taken into account by the central bank in regulating the size of the chartered banks' cash reserves. Thus, the central bank will evidently keep the cash reserves of the chartered banks from being as large as they otherwise could be, and the size of the control base on which the central bank acts will therefore be smaller, when other financial institutions are growing. If any of the growth is the result of other financial institutions having a cost advantage over banks in being free of reserve requirements necessitating holding more cash than would otherwise be held, it follows that the higher the reserve ratio imposed on banks the smaller the banking system will be. It would not seem to be in the interest of efficient monetary policy to let the control base shrink simply because the reserve ratio was set higher than it need be.

## SECTION II

## INVESTMENTS

### Purposes of Investment Portfolios

58. One of the primary functions of a chartered bank is to make loans. It follows that bank investment activities are normally subsidiary to bank lending activities. Since loans vary as a result of seasonal, cyclical, and irregular influences, a chartered bank must be able to adjust other earning assets up and down fairly readily in order to accommodate its borrowing customers and the investment portfolio permits this to be done, while employing the residual funds profitably.

59. A large proportion of deposits (about 40 per cent) is in current accounts which

are legally payable on demand, and most of the balance is in personal savings deposits which in practice are also paid on demand, even though notice could be required. Because of the large number of accounts involved, the deposits of an individual bank tend to remain relatively stable in relation to the total level of deposits in the system. However, over short periods of time a bank's deposits can be adversely affected by substantial withdrawals, as cheque payments are made by customers of that bank to customers of other banks, without an equal volume of offsetting transactions happening to go in the other direction. Under such conditions one bank can lose cash in the net clearing of funds while others gain. Such clearing fluctuations have become more pronounced since the broadening of the money market which commenced in 1954. The large corporate depositor moves his funds about in a variety of short-term instruments, and a fortuitous combination of several large transactions can have a substantial effect on the cash position of a single bank. In order to meet any conceivable cash withdrawal, large or small, on demand and without the slightest qualification as to its immediate availability, a bank must have readily realizable investment assets in addition to cash itself.

**60.** Generally, the further away from cash an investment is, the higher the rate of interest it earns. Hence the management of a bank's investment portfolio usually consists of steering a judicious course between low-yielding "near-cash" assets, and higher-yielding less-liquid assets. To be a "near-cash" asset in this sense, an asset should be not only readily saleable, but also saleable in quantity without significantly depressing the price. Almost any asset can be sold fairly quickly if the price is low enough, but few assets can be sold within the day. The most easily realizable assets are day-to-day loans, and Treasury bills issued by the Government of Canada. Ranked behind these assets, in terms of liquidity, are short-term Government of Canada bonds, medium-term Canada's, provincial short-term bonds, longer-term Canada's and provincial bonds, municipal and corporate securities, mortgages, and other assets, but not necessarily in that precise order.

**61.** It might be argued that commercial loans themselves are more liquid than many of the above investment assets, in that they are nominally callable on demand. In practice, however, a chartered bank does not "call" loans from its customers for reasons of general liquidity (except for day-to-day loans to the money market), and would be extremely loath to do so.

**62.** To give a balanced structure to the bank's assets, which is important for a flexible bank lending policy and for maintaining the confidence of the general public and of customers at home and abroad, the weight of risk assets must be balanced by a proportion of relatively riskless assets (riskless in the credit sense, though not necessarily in the market sense), such as securities of the Government of Canada. Other investments, such as provincial and municipal bonds, and corporate securities, have varying degrees of risk, though generally speaking the degree of risk on any of them is considered less than on most commercial loans. Even this is not always the case, as a commercial loan to a strong corporation is often less risky, and sometimes more realizable, than an investment in some municipal or corporate obligations.

**63.** In the maintenance of their investment portfolios the banks do from time to time participate in the financing of federal, provincial, and municipal governments, and to a lesser extent of corporations. As national savings institutions, the banks share in the task of providing funds for the financing of both current and short-term capital requirements of all three levels of government. The federal budget is one of the most significant factors affecting the size and nature of chartered bank investment portfolios. During the Second World War, huge budget deficits were financed in part by the chartered banks. In the first seven years after the war some federal debt was retired, and the growth of the economy brought other potential lenders into the market, so that bank holdings of Government bonds were reduced absolutely and also relative to other bank assets which

expanded under peacetime conditions. Since the mid-fifties, the re-appearance of sizeable Government deficits accompanied by more active monetary policies has led to a greater variability in bank holdings of Government securities.

64. The foregoing paragraphs surely demonstrate that the employment of surplus funds is a matter of continuous concern to the management of the banks, as is the maintenance of the combination of earning assets most appropriate to any given period of time. Such assets are normally in excess of the bank's liabilities to the public and therefore the often-heard claim that the banks have "idle savings deposits" is a complete misstatement of fact.

### Bank Investment Portfolios and the Business Cycle

65. As discussed earlier, short-run fluctuations in bank deposits and loans are met primarily by increases or decreases in "secondary reserves"—day-to-day loans and Treasury bills. Such fluctuations relate mainly to day-to-day movements in net clearings of deposits between banks, to short-run changes in cash reserves brought about by the actions of the Bank of Canada, and to seasonal and special influences, such as those related to changes in the public demand for bank notes or by the payment for large new security issues.

66. Longer-term movements in security holdings are likely to be related to cyclical influences which affect all banks rather than individual banks. An upsurge of business generally brings with it a rise in business inventories, an expansion of working capital requirements, and a general drain on the liquid assets of bank customers which causes them to employ more fully their existing lines of credit at the banks, or to seek larger lines. In recent periods of this kind the banks have been able to expand both their loans and their total assets only as long as the Bank of Canada has been prepared to expand the total cash reserves of the banking system and hence the total supply of money. When the expansion of the money supply has been brought to a halt by the central bank the chartered banks have been able to increase their loans only by selling securities. The process of liquidating securities when the total volume of bank deposits was constant, or rising only slowly, was a factor in a fall in bond prices and a rise in short-term interest rates, since buyers of securities did not appear except at lower price levels. In some circumstances the federal budget might have been expected to act as an offsetting factor, if under good business conditions the budget had swung over to the surplus side, enabling the Government to retire some of its maturing issues. More often the scale of demand for credit in the private sector of the economy had outrun the decrease in the Government's requirements so that the banks have found themselves selling their holdings on a falling market. Indeed, in the years since 1957 the Government has consistently operated at a deficit, thus adding to the pressure of demand for credit. As short-term security prices have fallen other institutions have been affected and the rise in interest rates has spread into medium-term and longer-term bonds.

67. When business is deteriorating, the demand for bank credit and competing forms of credit by the private sector of the economy tends to decline. If the federal government employs the counter-cyclical device of deficit financing, it may call upon the banks, directly or indirectly, to take up sizeable new issues of securities. The central bank may enable this to be done by providing the banks with sufficient reserves to support large-scale buying. Easy monetary conditions imply relatively low rates of interest, so that the banks have often found themselves buying bonds at high prices (low yields), knowing that later on they might have to sell at low prices (high yields)—in order to accommodate their customers when conditions changed and money became tight. The only way out of this dilemma has been to hold a substantial volume of securities which mature within a short time. Of course this means sacrificing yield for liquidity. Experience since the mid-fifties shows that the banks have learned that, given massive

government counter-cyclical fiscal policies and widely varying monetary conditions, their investment portfolios must be shorter than was the case formerly, and that more thought has to be given to anticipating changes in business conditions.

**68.** The effect of the cycle on the banks has been aggravated in recent years by the market reactions of other financial institutions, corporations, and the general public. In attempting to foresee changes in monetary and fiscal policies, both lenders and borrowers try to act in advance of the event. Hence interest rates may start rising long before a business recovery gets under way, and even in the face of continued monetary ease. Expectations of this sort have been significant in recent years, in the U.S. as well as Canada, and have helped to contribute to confusion as to the proper course to be followed by the monetary authorities.

**69.** Both domestic and external forces can create circumstances in which bond prices decline sharply. A notable example of such internal conditions occurred during the summer of 1959 when the pressure created by substantial sales of securities in a market where buying interest was nominal forced prices of short-term securities sharply downwards until yields were considerably in excess of six per cent. For example, on August 13th the average cost to the Government of Canada of borrowing by way of three-month Treasury bills was 6.16 per cent, and on September 14, 1959, the cost of borrowing in the form of one-year bonds was about 6.80 per cent and of three-year bonds 6.52 per cent. The Government of Canada, as the prime credit risk, is generally able to borrow at the lowest cost for any specific term. The cost of money to any other borrower should have exceeded these rates, and while this was true of borrowings in the market place, the banks were faced with lending at not more than six per cent, because of the limitations of the Bank Act. As a result, borrowers who might normally have been expected to have recourse to the market sought increased accommodation at lower rates from the banks, thus placing a further strain on bank resources. The substantial amounts normally borrowed outside the banking system were sought from banks in competition with the normal demand for loans arising in the business sector.

**70.** Even partial fulfilment by the banks of abnormal demands is difficult and expensive when loanable funds have to be obtained by liquidating securities at low market prices. The procedure is much more expensive and the problem more acute than is suggested superficially by the selling of securities yielding more than six per cent in order to invest in loans at not more than six per cent. For example, in the easy money period of 1958 chartered banks participated in the Conversion Loan by acquiring large holdings of the new Conversion Loan issues of three per cent due December 1, 1961, and 3¾ per cent of September 1, 1965, both of which were entered on the books of the banks at or near 100:

| | **3% Dec. 1/61** | **3¾% Sept. 1/65** |
|---|---|---|
| | $ | $ |
| Assume issues carried on banks' books at | 100.00 | 100.00 |
| If bonds sold on Aug. 26/59 | | |
| Market price obtainable* | 93.50 | 88.25 |
| Loss on Sale | 6.50 | 11.75 |

*Source: Bank of Canada, *Statistical Summary*.

**71.** Thus, within one year after the purchase of these issues market prices had declined because of tight money conditions by $6.50 and $11.75 per $100 par value, or, in other words, by $650,000 and $1,175,000 per $10 million par value. Moreover if, when the bonds were sold, the proceeds were invested in loans at the maximum rate of six per cent the loans would have had to be outstanding for extended periods before the increase in interest earnings would compensate for the substantial book losses, viz.:

nearly 30 months to recover the loss on three per cent bonds due December 1, 1961, and nearly 92 months to recover the loss on three and three-quarter per cent due December 1, 1965. These calculations are based on the maximum lending rate of six per cent, which would not be applicable to all customers, since the prime loan rate in fact never went above five and three-quarter per cent. Moreover, no allowance has been made in the calculation for the real possibility that lending rates might decline, as in fact they did before the end of the period during which the loans would have had to remain outstanding.

72. Obviously, neither bank nor customer expected loans made in 1959 to remain outstanding for such extended periods, so that the banks could not expect to recover the losses on securities sold. The banks were fully aware that they were taking substantial losses on securities, and also rapidly depleting their reserves of securities. At the same time, however, as the business upturn continued they were under pressure to continue making loans to their customers. In April of that year the prime loan rate reached 5.75 per cent and there was no further possibility of rationing credit by price, that is, through interest rates. The banks then asked their large customers, especially those who were making use of non-bank sources of credit, to reconsider their requirements for bank funds, and some of the large lines of credit were reduced by agreement. Throughout this period, however, the banks made a deliberate effort to continue to meet on a normal basis the requirement of small borrowers. In May 1959, the banks made a joint announcement that they would exercise the utmost care in the handling of their credit facilities in order to avoid any significant further increase in the over-all total of bank loans. Despite this announcement the demand for loans continued to rise sharply, to a considerable extent because the level of market interest rates had been pushed above the six per cent ceiling on bank loans. Market influences, therefore, provided an incentive to seek accommodation through the banks for new money requirements, and to delay the reduction of bank loans by normal funding operations. The crisis of liquidity came to a head in the abortive Treasury bill tender of August 1959; shortly thereafter the demand for bank loans began to recede.

73. How far can the process of selling securities go before a bank feels that its liquidity is at a minimum level? This depends on several factors, which are: (1) the extent of the rise in yields and the concurrent fall in prices, and hence the cost of liquidating securities; (2) the size of the unused portion of established lines of credit; (3) the size of the portfolio of securities, both absolutely and in relation to other banks, and the speed with which it is being reduced; (4) the views of the monetary authorities; (5) the ability and/or willingness of bank managements to change their lending policies; and (6) expectations regarding the above factors.

74. Experience of the two periods of extreme monetary tightness which occurred in the 1950's gives some indication of the minimum levels of Government portfolios considered essential by the banks in such circumstances. In late 1959, for example, with cash reserves at eight per cent and secondary reserves scraping the seven per cent minimum agreed levels, the banks held combined portfolios of Canada's aggregating less than 15 per cent of Canadian dollar deposit liabilities. Hence it is clear that the Government securities portfolio is reducible only within limits, beyond which the banks regard it as essential to the general safety of deposits.

### Government of Canada Bond Portfolios

75. The general policy considerations relating to the size and character of the chartered banks' portfolios of Government of Canada bonds have already been set out. The facts regarding these portfolios may now be summarized briefly.

76. In 1954-55, credit extended by the banks in the form of Canadian loans, mortgages and non-federal government securities amounted to about 52 per cent of

Canadian dollar deposits. By 1960-61 such accommodation had increased to 65 per cent of deposits. This percentage is the highest since the 1920's, and it has been maintained for some two years. There has thus been an upward shift in the proportion of loans to deposits, and a corresponding downward adjustment in the level of security holdings which the banks have been prepared to accept.

**77.** The introduction of N.H.A. mortgages in 1954 and the secondary reserve agreement which came into effect in 1956 of course had important effects on the investment portfolios of the banks. From 1954 to 1961 N.H.A. mortgages grew to about seven per cent of Canadian deposits. Holdings of Treasury bills were increased from 3.2 per cent in March 1954 to roughly eight per cent to nine per cent in 1961. In addition, the banks at the latter date held about one per cent of deposits in the form of day-to-day loans. Government securities, other than Treasury bills, which constituted roughly 29 per cent of deposits in 1954, were only 18 per cent of deposits in 1961.

**78.** A classification of Government of Canada bond holdings seems to suggest that the increased requirements for Treasury bills have not produced any lasting decrease in holdings of bonds maturing within two years, which are required for liquidity purposes. (It should be pointed out that it is not the 15 per cent liquidity requirement which provides real liquidity to the banks, but only the excess of secondary reserves above 15 per cent, plus the holdings of short-term Canada's.) The ratio of under-two-year holdings to Canadian dollar deposits was seven per cent in March 1955 and 7.7 per cent in December 1961. In the interval, there were periods when bank holdings of "shorts" went down to figures as low as three to four per cent of deposits, in the tight money squeezes of 1956, 1957 and especially 1959. On each of these occasions, the banks "ran off" or sold their shortest maturities, but their sales of medium and long bonds were less because of the large irrecoverable losses which would have been incurred.

**79.** The Conversion Loan in 1958 induced some lengthening of portfolios, especially in the over-ten-year category. But the banks shortened up again in late 1958, and have subsequently reduced their percentage of over-ten-year holdings. The percentage of Government of Canada bonds in medium-term maturities (five to ten years) has declined significantly, as has the average maturity of bank holdings.

**The Non-Federal Portfolio**

**80.** Bank holdings of "non-Federal securities," i.e., provincial, municipal, and corporate securities, are discussed below. Holdings of such securities are small relative to holdings of Canada's, and they do not perform the same function as do the securities of the federal government. That is, they are not related directly to the problem of maintaining short-term liquidity against fluctuations in loans and deposits, primarily because they do not enjoy as broad and active a market as do federal obligations.

**81.** On the other hand, holdings of provincial and municipal bonds are by no means divorced from liquidity considerations altogether. The banks tend to buy short-term and medium-term provincial bonds, rather than long-term issues. Their municipal holdings are confined very largely to serial issues maturing within five or ten years, partly because this suits the asset structure of a commercial bank, and also because it helps to facilitate the repayment of debt by the municipality over a full 20-year period, with longer-term investors subscribing for longer maturities as a rule.

**82.** The banks buy provincial and municipal securities to obtain good yields combined with an early return of capital, and to assist in the underwriting and marketing of such issues.

**83.** Corporate securities are also held in bank portfolios in part to accommodate borrowing customers. They are sometimes acquired in relatively large blocks, and are frequently hard to distinguish from term loans except in form. During periods of easy money, such as in 1955, banks have been substantial buyers of corporate bond issues, but

in recent years holdings of such bonds have been gradually running off without being fully replaced.

84. The banks do not purchase equities to any great extent, largely because they are foreign to the main purpose and nature of a commercial bank.

85. The amount of provincial and municipal securities held by the chartered banks has been rising gradually in recent years but has not grown as rapidly as total bank assets. At present holdings of these securities amount to about four per cent of Canadian dollar deposits. It might be noted that fluctuations in bank holdings of municipal debentures from year to year have tended to be in a somewhat narrower range than the variations in holdings of provincial bonds; the principal reason is probably the continuing supply of municipal offerings by way of short-term serial issues.

86. Bank holdings of provincial and municipal obligations while continuing to be substantial, have been declining as a percentage of the total outstanding debts of these two levels of government. Among the reasons for this decline are the relatively rapid growth in provincial and municipal debt and the lengthening of the terms for which provinces and municipalities borrow, and the recourse of provinces to other sources of funds.

87. The pressure on bank resources has tended to limit bank buying of provincial and municipal securities during periods of tight money in particular. During periods of easy money, the current flow of such securities has been sufficient to replace maturing holdings, but not sufficient to raise the percentage of assets held in this form to any appreciable extent. In addition, the banks have found it possible, during periods of tight money, to dispose of some short provincial issues which had low coupons and which therefore appealed to certain taxable individuals and corporations.

88. Another factor is that the provinces and their important agencies, such as the Hydro authorities, have tended to borrow for longer terms than the banks find appropriate to chartered bank investment objectives. This in turn reflects the nature of their capital works, which have been increasingly long-term in character, i.e., schools, hospitals, sewer plants, hydro installations, and so forth.

89. Banks may purchase corporate securities either through the market as a profitable outlet for surplus funds or directly from borrowers at the time of issue as an accommodation for their customers. The latter type of purchase is related to the granting of term loans which is discussed in Section III. Whether a particular borrower should be urged to go to the market or not will be influenced to some extent by whatever is the current policy regarding term loans. It will also be influenced by other factors, including the receptivity of the market itself, the nature of the customer's requirements, and also the important matter of a proper balance between floating and funded debt in the corporate structure.

90. In the past few years chartered bank holdings of corporate securities have fluctuated between $450 million and $550 million and are currently about 3.5 per cent of deposits. These holdings expanded considerably during the easy-money period of 1954-1955 when the capital investment boom was getting under way, but have shown a continuing slow decline since then.

91. During the tight money conditions which prevailed in varying degrees for most of 1959, the corporate securities holdings of the chartered banks declined $40 million, or 7.2 per cent, which probably represents the amount of maturities. This points to the principal disadvantage inherent in this type of investment, that is, the lack of marketability. On the other hand, the continuing decline in corporate securities during the comparatively easy money conditions of 1961 indicates that the banks have not resumed their participation during this latter period, partly because business demands for capital funds have been relatively modest.

# SECTION III

## LENDING

### General Credit Policy

**92.** Traditionally, the chartered banks have been the primary source of short-term business working capital. Since the war the Canadian economy has grown rapidly and in this climate the banks have been expanding their facilities and broadening and developing both deposit and lending services. Changes in bank lending policies have been encouraged by the new opportunities of the postwar economy, by the introduction of new types of Government-guaranteed loans for special purposes, by the example of developments in banking in other countries, especially the United States and the United Kingdom, and by very active competition among the chartered banks themselves. The result is that although the main emphasis is still on short-term commercial loans, the banks are now accustomed to make loans for a much wider variety of purposes than they were in 1935.

**93.** Bank lending policy is formulated by the management of each bank, taking into account market conditions, general economic trends, and changes in monetary policy. Lending policy may be revised, for example, if weakness appears to be developing in a particular industry. The banks may try to discourage their customers from over-expansion in that line. Policy changes of this kind reflect the continuous assessment of credit risks which is a part of the ordinary process of banking. In addition, however, as the business cycle moves from one stage to another, changes in official monetary policy will produce corresponding changes in the lending policy of the chartered banks. If this latter process is to work smoothly it is necessary that official policies be adequately signalled and clearly understood.

**94.** In administering credit policy it is usual to establish lines of credit for major customers who have a continuing need for accommodation. A line of credit is a stated amount within which a bank has indicated its willingness to accommodate a customer for a stated period of time, subject to the customer's continued credit-worthiness and to the maintenance of any conditions which may have been agreed upon between the customer and the bank, and subject also to general monetary conditions. It is usual for all commercial borrowers to operate under lines of credit but in practice other customers may also arrange to borrow in this way.

**95.** The line is commonly reviewed once a year, at the time that the customer's balance sheet becomes available, and he is able to project his financial position a year ahead. However, it may be reviewed at other times if the customer gets into difficulties or if there is a credit crisis, as in the summer of 1959. The line of credit lets the customer know how much credit he may normally expect in his operations, and authorizes the branch manager to make loans to the customer up to the agreed amount as long as there is no adverse change in circumstances.

**96.** Banks view their lines of credit with a real sense of responsibility. As long as a line of credit is outstanding the bank's management regards itself as committed to making loans within the stated limit, subject to maintenance to the credit-worthiness of the borrower and subject also to the general availability of loanable funds. Credit stringency may on occasion require the reduction or adjustment of credit lines, which may impose some hardship on the borrower; however, normally a full discussion is held with the borrower before such actions are taken. Even in the credit crisis of 1959 the banks continued to provide funds under lines of credit in conditions of extreme difficulty and when the cost, in terms of losses on securities sold to provide available loan funds, was very great.

**97.** Bank lending policy is applied by issuing instructions to credit supervisors at the head office, to the various regional offices and to branch managers across the country,

who are expected to follow them closely in making the loans which fall within their discretion. In this connection it may be noted that the period since 1955 has been the first for a generation in which the branch system has had to adjust to a changing monetary policy. Moreover, on occasion the somewhat obscure nature of monetary policies has made it difficult for head offices to determine and communicate appropriate policies to branch managers. Once a given policy is established, there is a natural reluctance to introduce changes in lending policy until conditions have changed to such an extent that a modification is clearly indicated.

**98.** There are other practical problems which arise in adjusting lending policies to changing economic conditions:

(i) The banks may not be sure that a significant change is required until it is late in the business cycle. This is partly a matter of assessing business conditions correctly, of interpreting the policy of the monetary authorities properly, and of allowing for the leads and lags which frequently occur in the behaviour of demand for bank loans. Generally, bank loans are thought to lag behind a business recovery, but this was not the case in 1955-56. Again, bank loans may rise because business is deteriorating rather than improving, or they may rise as business acquires larger inventories ahead of a real improvement in business. When reviewing individual accounts it is often difficult to interpret from loan changes what the underlying changes in business have been. A further complexity is the problem of sorting out seasonal from other influences.

(ii) Adjustments in bank lending policies, apart from interest-rate changes, take effect primarily through alterations in lines of credit, and thus take some time to have their full effect. A changed policy can be applied at once to applications for new or increased lines of credit, but it is not possible to review all existing credit lines and loan commitments at once. Indeed, the head office of a bank may not even know what its aggregate loans are doing until eight days after the event, i.e., until the make-up of figures for the preceding Wednesday week. It is extremely difficult for banks to anticipate the take-up of unused lines of credit.

(iii) In addition to the above factors, there is the natural tendency of commercial bankers to make good loans whenever possible. The training of branch managers is aimed at the development of officers who can seek out lending opportunities and make good loans. The manager's recognition and advancement depend to a significant degree on his ability in making loans. He therefore finds it difficult to accept a policy of refusing loans or cutting back the existing lines of credit-worthy customers.

**99.** It should be remembered that the Canadian branch banking system has an important degree of built-in flexibility, because behind each branch stand the resources of a large nation-wide institution. The branch is not limited to its own resources, and subject to the general availability of funds each borrower may be dealt with on his own merits without regard to the position of the branch.

**100.** The sharp fluctuations in monetary policy have in many cases encouraged customers to protect themselves against possible restrictions by asking for a line of credit higher than their normal needs. The introduction of stand-by charges has often been suggested as a way of bringing lines of credit down closer to actual borrowings. Stand-by charges would probably have the advantage of discouraging customers from asking for unreasonably large lines of credit, and thus make it easier for the banks to predict the trend of their loans and so manage their resources more efficiently. Stand-by charges would also be likely to discourage large customers from using the banks as "umbrellas," i.e. establishing big lines of credit but using them only when they cannot borrow more cheaply elsewhere.

**101.** On the other side, however, there are a number of reasons why the banks are

reluctant to impose stand-by charges on all lines of credit. As long as the line does not have a contractual status the bank knows that it can protect itself by reconsidering credit facilities if necessary; if a fee were exacted the bank might, in the absence of protective provisions, be legally committed even if circumstances changed drastically. Normally there are wide fluctuations in each loan account over the period of a year. For example, a customer may buy inventory and require working capital to finance it, then when he sells the inventory he may still need funds to finance his receivables. Finally, the loan is paid off. Such fluctuation in an account is a healthy sign. If the customer had to pay a stand-by charge he might borrow the full amount and try to employ the funds somehow even when he didn't need them in his operations. This would make it difficult for the bank to have a proper understanding of his position and, more important, would deprive the banks of one of the big factors in their flexibility. At present loans in different industries follow different seasonal patterns, so that loans to merchandisers, for instance, are at their peaks at a different time from loans to the construction industry. The banks can count on this pattern, so that there is a continuous ebb and flow of loan demand, and it never happens that all lines of credit are drawn down to their maximum amounts at the same time. If all borrowers always borrowed their total line of credit the banks would have much less flexibility in their operations and much less freedom to manoeuvre, to take on new customers or take advantage of opportunities in lending or investment as they arose.

**Credit Allocation**

**102.** The maximum rate of interest which banks could charge on their loans was seven per cent until 1944, when it was lowered to six per cent. At that time the general structure of interest rates was low and the ceiling had little if any significance. From 1944 to April 1956 the prime loan rate of the chartered banks was 4.5 per cent, but it rose gradually to 5.75 per cent by August 1957 and has varied only between 5.25 per cent and 5.75 per cent ever since then. This means that the banks are no longer able to use an increase in lending rates to moderate pressures on lending resources. It also means that the differential between yields on accounts involving varying risks or varying service requirements is almost eliminated. The ceiling forces bank lending rates into a rigid pattern in which almost all borrowers pay much the same rate. Without the ceiling a flexible range of rates would be substituted for the present fixed level.

**103.** When credit is scarce and the banks are unable to raise lending rates further, they do not usually establish special restrictive policies regarding loans to particular industries, and never do so in respect of loans in particular regions. Certain types of loans are usually curtailed as less essential, such as term loans for projects which could be financed outside the banks, loans to buy securities or real estate for speculative purposes. Loans to other credit-granting institutions are also restricted when money is tight. In the main, however, the process of rationing credit involves reviewing each individual loan account on the score of the borrower's need for the funds, his possible alternative source of funds, the collateral advantage to the bank from the account, and any competitive factors which may be involved. It cannot be emphasized too strongly that having to implement a tight-money policy by placing restrictions on individual borrowers, having to choose among equally creditworthy customers and having in effect to decide which projects may go forward and which may be stopped by lack of funds, is a difficult and disagreeable task, but one which in the boom phase of the economy sometimes becomes necessary in order to conform to current monetary policy.

**104.** In the first instance a bank will usually restrict borrowing which appears to be non-essential. When a customer's balance sheet is examined it may appear that the line of credit which has been asked for is high relative to the size of the business. This may be because the borrower is trying to protect himself against tight-money conditions

which he fears may arise in the future, or the customer may want a larger line of credit for prestige reasons, or the customer may be carrying inventories which are too large relative to sales, either because he is inefficient or because he is speculating on his inventory. In such cases the bank will probably tell the customer it considers that he is asking for more money than he needs.

**105.** Credit is not rationed on the basis of size of account. The banks have always assumed that their primary responsibility was towards their smaller business customers. The subject of loans to small borrowers has been reviewed with the Bank of Canada on various occasions since 1955 when the first tight-money period began. The withdrawal of the banks from the term loan field of lending did not apply in the area of small business and every effort has been made to meet the needs of those borrowers whose size does not enable them to obtain funds by issuing securities or other means.

**106.** The banks have recently carried out four surveys of outstanding loan accounts classified both by industry and by size. The most recent survey, at September 1961, gives an analysis of loans totalling $5,830 millions. A few categories of loans were not included in the analysis. These were loans to provincial and municipal governments, to investment dealers and brokers and to grain dealers and exporters. Of this amount 32 per cent was in accounts of under $10,000, and 52 per cent was in accounts of under $100,000. Classified by number, 96.6 per cent of all borrowers were in the under $10,000 category and only 0.54 per cent had accounts of $100,000 or more. The proportion of total loans made available to smaller borrowers has risen slightly with each survey.

**107.** It must be realized, however, that in times of extreme credit stringency the banks will be obliged to curtail loans for the purpose of carrying securities or for speculative purposes and small borrowers in these categories will be affected in the same way as the larger ones, the prime objective being that of conserving lending resources for basic needs.

**108.** Direct controls on bank lending have not been used very much in Canada. During the war, however, the general restrictions imposed on consumer loans were applied to bank borrowers as well as to those who borrowed from other institutional lenders. These restrictions were not a part of ordinary monetary policy but were imposed by the Government under its wartime emergency powers. Consumer credit regulations were introduced again at the time of the Korean War. In addition, by agreement with the Bank of Canada in 1951 the chartered banks held a ceiling on their total loans for a year, and undertook specifically not to add to their loans to instalment finance companies or to loans for capital purposes.

**109.** Since 1952 (apart from the secondary reserve agreement of 1955, which restricts the proportion of bank assets available for loans), the only direct controls on particular borrowers have been those on term loans and on loans to instalment finance companies. At the suggestion of the Bank of Canada the banks have curtailed these two types of loan from time to time, especially in periods of tight money. When credit has been scarce term loans have been cut back on the ground that if the borrowing is necessary it can and should be carried out in the capital market. Similarly under conditions of credit stringency, loans to instalment finance companies have been limited partly because of the central bank's desire to discourage the use of consumer credit, and partly because the finance companies themselves have access to the money market. Furthermore, when lending in general has to be restricted, it is only fair and proper that the access of instalment finance companies to bank credit, for re-lending to the general public, should also be curtailed along with the loans the banks make directly to the general public.

**110.** Despite these considerations, however, the banks are not in favour of direct controls on loans to finance companies whether imposed by the central bank or the Government. If one group of institutions is to be restricted in this way it would be only logical to apply controls to all other financial institutions, and the banks are not in favour

of a widespread system of controls. Moreover, a small finance company, like any other small business, is much more dependent on its banks for funds than is a large company. If bank loans to the small finance companies were curtailed they would have great difficulty in finding alternative sources of funds. This example illustrates the problems which arise in attempting to apply selective controls on bank lending. Similar problems would arise in attempting to enforce special credit policies towards particular industries or regions.

**111.** We believe that any form of selective controls on bank lending would reduce the flexibility of the Canadian banking system which has been one of the strongest factors in the growth of the economy. The responsible authorities, with the best intentions, may try to channel credit into specific areas. But in a growing and developing economy, conditions, markets and industries change rapidly. How much credit is needed in each sector at any given time is a matter of judgment, and the banks' view is that the question is more safely left to the combined judgment of the banking system and other financial institutions, based on competitive market forces and carried out in co-operation with general Government and central bank policies, than to any arbitrary system of controls.

**Loans under Sections 82, 86 and 88**

**112.** One of the most distinctive features of bank lending in Canada, which is not a postwar development but goes right back to the 19th century, is the legislation which allows a chartered bank to make advances on the security of natural products and goods, wares, and merchandise while they remain in the borrower's possession. This is Section 88 of the Bank Act. Similarly, Section 86 of the Act provides that a bank may lend on the security of warehouse receipts, bills of lading, etc., and Section 82 makes provision for banks to make advances to oil operators on the security of hydrocarbons in, under, or upon the ground. All these sections were designed to encourage the development of Canadian resources by enabling producers, wholesalers, and manufacturers to borrow more than they otherwise could to meet the essential financial needs of their business pursuits. Parliamentary records show that the same motive was behind subsequent steps in the development of this feature in the banking system. These sections of the Bank Act are a means of providing support in many fields of endeavour to an extent which otherwise would not be practical from the standpoint of prudent banking. This applies particularly to what may be termed smaller business enterprises with limited financial resources, and often to business enterprises at an early stage in their development, before they have sufficient resources to qualify them for bank credit in the ordinary way.

**113.** In addition to small businesses, individuals and farmers there are a substantial number of well-established middle-sized businesses in Canada engaged in manufacturing or processing raw materials which must depend on inventory to support or secure borrowings for operating purposes. These firms require bank advances for the purpose of meeting wages, accounts payable to suppliers, overhead, and other expenses in the ordinary course of business. Section 88 enables such firms to use their inventory as security for bank loans, and it is through assistance in this manner that raw materials end up as finished products for sale in the domestic or foreign market.

**114.** One example that could be given as an illustration is that of a manufacturer with only a modest working capital but with a reasonable investment in fixed assets. He has an inventory valued at $150,000 and accounts receivable totalling $100,000 and he wishes a bank credit of say $125,000. It would be usual to advance a percentage of receivables, which we will say in this case is 75 per cent, equalling $75,000. Security would be taken under Section 88 against inventory and this would provide the basis to increase the loan to $125,000, thus meeting the customer's requirement. Without the provisions of Section 88 it would likely not be possible to give this manufacturer the support he requires, which could make it difficult, or even impossible, for him to continue

a normal operation. This example is simply to illustrate that financing of receivables would not always suffice, and security against inventory supplies the means to provide the additional funds required in his operation. At this stage in the development of the Canadian economy there are still many business concerns of this kind, so that Section 88 of the Bank Act is a fundamental link in the chain of financing economic activity in this country.

115. A classification of loans outstanding in mid-November 1961 for which security had been taken under Sections 88, 86 and 82 is summarized here. The statistics cannot be analyzed too precisely because in many cases more than one type of security is involved in the loan account.

| | Number of Borrowers | Authorized Credits | Amount of Advances |
|---|---|---|---|
| | | $'000 | $'000 |
| Under Section 88 | 33,180 | 1,554,990 | 924,895 |
| Under Section 86 | 345 | 250,029 | 85,999 |
| Under Section 82 | 114 | 73,672 | 48,929 |
| | 33,639 | 1,878,691 | 1,059,823 |

Agriculture is one of the most important areas to which these sections apply. About 27,000 of the 34,000 borrowers classified at November were farmers, and in addition most Farm Improvement Loans are supported by security provided under Section 88. Advances may be made for the purchase of seed grain, seed potatoes or fertilizer, secured by the crop to be grown. Loans may also be made on the security of livestock, thus assisting farmers to diversify their operations, and on agricultural implements, thus encouraging greater efficiency of production. The financing of grain inventories held in country elevators has also been facilitated by means of these sections. Canning and fish processing have been assisted substantially. The forest products industry and the mining products industry are large areas to which Section 88 applies. In manufacturing, many small and new businesses have received bank support through Sections 86 and 88 which they could not otherwise have had. Those types of business which show a sharp seasonal movement have found this kind of bank accommodation particularly helpful. Sometimes inventory is manufactured in one season to cover sales for a whole year, as in the canning industry. Or inventory may be built up all year for one concentrated sales period, as in the case of the manufacture of toys. Assistance is often required to finance the accumulation of this inventory to meet future delivery dates, with Section 88 providing the basis.

116. Altogether the sample figures show that in November loans outstanding under these Sections of the Bank Act were just over $1 billion, which would be about 18 per cent of total general loans outstanding at that time. Although, because of the fact that there is often more than one type of security behind a given loan account, it is impossible to say what proportion of the loans could not have been made without the use of Sections 88, 86, and 82 of the Bank Act, it is likely that most of these borrowers would not have been able to borrow, or would have borrowed at higher rates from other institutional lenders. In many cases the rates charged by other lenders for loans on basic materials would have been so high that the business could not have been undertaken profitably.

117. In the absence of the provisions of Section 88 of the Bank Act, the banks could acquire security over the inventories of corporate borrowers through the medium of collateral debentures as provided for in s. 75 (5) of the Bank Act providing a floating charge over inventories as well as all other current assets. In many cases, however, such a procedure would be impractical. In any case it would be costly to the borrower and it

would not be available to individuals or partnerships, who constitute a very large proportion of Section 88 borrowers, particularly in the field of agriculture.

118. In summary, we believe it would be difficult to exaggerate the importance of the availability of Section 88 security to borrowers as a means of financing a very significant part of Canadian production.

### Term Loans

119. As a general principle large business corporations should expect to rely on the chartered banks primarily in respect of short-term working capital needs and should finance their longer-term capital requirements by selling securities in the market. Some longer-term borrowers may, however, be accommodated by the chartered banks through term loans, particularly smaller firms whose requirements for funds are relatively modest and for whom the costs of a market issue, in terms both of interest and of underwriting cost, would be disproportionately high.

120. Following a period of loan expansion which started in the middle of 1954, the Bank of Canada suggested in November 1955 that it would be desirable for chartered banks to refrain from making commitments for term loans. It was pointed out by the Bank of Canada that the proposed restrictions need not apply to housing loans, loans to provinces and municipalities, farmers and other individuals. The banks agreed on November 30, 1955, that they would refrain from making term loans (then defined as loans that would be outstanding for more than a year) for amounts in excess of $250,000. Subsequent experience showed that there was need for greater flexibility, and it was agreed that the general objective would be served by a limit which would permit small businesses to obtain greater term accommodation. The limit has been changed from time to time, and is currently $1 million. Though the definition has also been changed, term loans are currently considered to be loans in respect of which repayment is scheduled in more than two years from the date of the initial advance, even though subject to annual review. At the end of 1961 total chartered bank loans outstanding under authorized credits of $1 million and over amounted to about $1.5 billions, and of these about $50 millions were classified as term loans. In addition, bank holdings of corporate securities totalled $470 millions, though some of these would have been market purchases.

### Personal Loans

121. The banks have always made loans to individuals for a great variety of purposes and with a great variety of repayment arrangements, within ordinary banking practice. Some of these loans were very similar to the instalment loans now being made. In the 1930's, however, there was a good deal of public criticism of the rates charged for small loans by some lenders, and this led ultimately to the first Small Loans Act, passed in 1939. Against this background one of the chartered banks began in 1936 to offer a special kind of personal loan which may be called an instalment credit loan. Full details of this plan were presented to the Banking and Commerce Committee in 1944 and 1954. During the past few years most of the other banks have also set up instalment credit loan plans, a development facilitated by the 1954 revision of the Bank Act which allowed the banks to take chattel mortgages as security. This development was also encouraged by the fact that banks in the United States had been successful in the consumer credit field for a number of years and that banks in the United Kingdom also entered the field on a large scale in 1958. In general, the banks have set up these programs to reach a group of borrowers who, while unable to provide collateral in the traditional form, are nevertheless creditworthy, and who wish to borrow for worthwhile purposes usually connected with their homes and families. We believe that consumer instalment credit has become firmly established and that such loans are a logical development of banking services. The extensive branch bank system is highly suitable for providing consumer

credit. Because the banks already have well developed facilities they are able to offer consumer credit at rates which (including service charges) are more favourable to the borrower than those charged by specialized institutions. The banks are also well aware that a customer who comes into a branch initially for an instalment credit loan is likely to want to make use of the other services offered by the bank, so that these loans attract other business.

122. The most important category of instalment credit loans is loans for the purchase of automobiles, but large numbers of loans are also made to finance the purchase of furniture, to pay medical bills or holiday expenses, and to consolidate debts. The main characteristic of such loans is that they are intended to be repaid out of future income of the borrower and are usually repaid in equal monthly instalments on an amortized basis. They are usually made for an overall term of not more than 36 months, and not usually for an amount of more than $5,000. A normal feature is insurance to repay the balance of the loan in case of the death of the borrower.

123. Although instalment credit loans of the chartered banks are not shown separately in bank loan statistics, total personal loans in the group which includes loans made under these programs (that is total personal loans excluding those fully secured by marketable bonds or stocks and Home Improvement Loans guaranteed by the Government) stood at $1,029 million at the end of December, 1961, compared to about $350 million at December, 1954. Of course instalment credit granted by other lenders has also been rising in this period. It is estimated, however, that the chartered banks' share of consumer credit has risen from about 21 per cent to 32 per cent since 1954.

**Mortgage Lending**

124. Legally, Canadian chartered banks were not allowed to take mortgage security except as subsequent security, but in 1954 a major change in the Bank Act was introduced which enabled the banks to acquire mortgages securing loans under the National Housing Act. From 1954 to the end of 1959 the banks approved N.H.A. mortgages to a total of $1.3 billions, accounting for about 35 per cent of all N.H.A. loans made in this period. By the end of 1959 N.H.A. mortgages were about six per cent of total chartered bank assets. In 1959 monetary conditions were such that the banks' lending resources were under heavy pressure and the rate of mortgage loan approvals declined sharply. In December 1959 the maximum N.H.A. rate permitted was raised by the Government to 6¾ per cent, and although banks could still process N.H.A. mortgages, counsel's opinion was that they could not do so at a higher rate than six per cent because of the legal ceiling on bank lending rates. The result was virtual cessation of N.H.A. lending by the banks, since if they had made mortgage money available at six per cent while all other lenders were charging 6¾ per cent the banks would have been faced with very large demands for funds and an impossible task of credit rationing. It is, however, permissible to invest in N.H.A. mortgages initiated by other lenders, and in recent months the banks have acquired small amounts of mortgages which have been sold at tender by Central Mortgage and Housing Corporation.

125. Although the banks were somewhat reluctant to enter the mortgage field in the beginning, their experience in the field has been favourable. Now that they have built up efficient departments to initiate and service mortgage loans and have acquired such a substantial stake in the mortgage lending business (which is essentially a long-term operation) it is in the public interest that they should be allowed to participate in N.H.A. mortgage lending on a continuous basis at whatever may be the going rate of interest for such loans, even though there may be fluctuations in the supply of and demand for mortgage funds from year to year.

126. From time to time arguments have been advanced against the desirability of the banks being authorized to lend on mortgage security generally, and therefore against

extending their powers to that they can hold conventional mortgages. For one it is said that the chartered banks are responsible to their depositors, who make up a very substantial proportion of the population of the country. The deposits of the chartered banks are repayable on demand or short notice and the banks must always be in a position to observe the terms on which funds are entrusted to them by depositors. Thus, liquidity is essential and long-term mortgages are not a liquid security at present and a secondary market is only slowly developing. Since the problems of the nineteen-thirties were great and numerous it is also suggested that one reason for the avoidance of a banking crisis in Canada was the fact that the chartered banks did not have deposit funds invested in long-term loans on real estate. While the banks do now have such investments in the form of N.H.A. mortgages, these mortgages carry a Government guarantee supported by an insurance fund, so that any real estate acquired after foreclosure or otherwise is quickly converted into cash. Another argument is that granting conventional mortgages on various types of properties is a specialized field and many problems of valuation, terms of repayment, titles, etc., arise. It is said, therefore, that it would be difficult to set up the necessary lengthy and complex instructions for a widespread branch system. Finally it is said that historically the chartered banks have not entered into this field and specialized institutions have developed for the purpose.

**127.** The possibility that enabling the banks to engage in mortgage lending would undermine their ability to serve their depositors and to fulfill their functions as commercial banks is considered to be without foundation. The history of banking shows that a portion of a bank's deposit funds may, subject to proper safeguards, be made available for long-term investment. The developing success of most other institutions that compete with the banks for savings deposits can be traced to their freedom to employ a portion of such funds in housing loans and other longer-term investments. In other countries these are recognized as perfectly normal and appropriate outlets for a portion of the deposits held by savings banks and other institutions and, in Canada, savings depositors are showing an increasing preference for the sort of savings institution that is permitted to invest in conventional mortgage loans.

**128.** The present-day practice of requiring regular amortization of mortgage contracts greatly reduces the risk of losses compared to the experience of the 1930's when such provisions were not customary. It now is generally accepted that the fact that United States banks held mortgages on real estate was only one of many factors which contributed to the banking crisis in that country and was by no means a decisive factor in their difficulties. The fact that banks in the United States again are engaged in conventional mortgage lending as one of their major services lends support to this observation.

**129.** Conventional mortgage lending would further broaden the services which the chartered banks render their customers and would help to ensure a sufficient supply of mortgage funds from private sources. Estimates of housing requirements for the years ahead indicate the banks could render useful service if granted the same freedom as other lenders in the field. This should permit more public funds to be directed to special programs such as low rental housing, housing for elderly people, etc.

**130.** Existing Bank Act restrictions have the effect of shielding the conventional mortgage market from bank competition. Participation of the banks in the field should lead ultimately to a narrowing of the spread between typical mortgage rates and the return on savings with beneficial results to the public. Other mortgage lending organizations collectively offer quite extensive competitive facilities in the larger centres but smaller cities and towns where the banks already are represented are not adequately served by institutional mortgage lenders.

**131.** The chartered banks have acquired substantial portfolios of N.H.A. mortgages. The mortgage procedures as laid down in the National Housing Act do not permit re-financing of mortgages either to increase the principal owing or for any other reason.

When a property is sold by the owner, the purchaser normally assumes the existing mortgage and either pays all cash for the difference or part cash and gives back a second mortgage to the vendor. In the years ahead, as principal owing reduces on each mortgage, a purchaser is more likely to require a larger mortgage than the one then existing. Consequently it is more than possible that a new higher conventional mortgage will be obtained (say to 66 2/3 per cent of the then appraised value) and the existing N.H.A. mortgage paid off in full. If banks cannot handle this re-financing by making a higher conventional mortgage loan, they could eventually find principal repayments being made in very substantial proportions, depleting existing portfolios quickly. If the chartered banks are able to make conventional mortgage loans, a means of reinvesting the repayment funds will be available and this would also enable the banks to render the vendors and purchasers a service by making it unnecessary for them to seek accommodation elsewhere. Banks are permitted to assist customers in the purchase or construction of dwellings financed under N.H.A. and should also have facilities to assist those who for various reasons wish to do their financing by means of conventional mortgages.

132. As the Bank Act now stands it is possible for the chartered banks to buy bonds or debentures issued against mortgage security, which in effect amounts to a form of mortgage lending, and it is inconsistent to deny them the power to make direct mortgage loans.

133. More and more, as other legislation is created, for example, the Small Businesses Loans Act, the National Housing Act 1954, and the Farm Improvement Loans Act, special provision is required authorizing banks to take mortgage security for specific items in order to overcome the Bank Act restrictions. In the conduct of the banks' ordinary business too, there are many occasions where being able to take mortgage security as collateral would make the difference between granting or refusing to assist a customer and again there seems now to be no good and valid objection to granting to banks the widest powers in this direction. A typical situation of this sort might involve a medium-term loan to a smaller business readily available from its present bankers if they were not prohibited from taking mortgage security over real property. As matters stand the customer probably turns to the Industrial Development Bank only because the Government bank is not confined by similar restrictions.

134. On balance we think the public interest would be best served if the banks were freed from the existing restriction in the Bank Act with respect to the taking of mortgage security, thus leaving the banks free to exercise their own discretion in this area of lending. As to safeguards in the public interest, the Canadian banking system has a proven record of the sort of judgments it brings to bear on loan policy throughout the country. Mortgage lending on a fully competitive basis would evolve in an orderly fashion, it would be carefully geared to the necessity for adequate liquidity, and the pace of the advance would be carefully measured.

135. In a related context the powers of the banks to take specific security in the course of lending operations appear to be unduly limited in the light of present day requirements. For example, the power of the banks to take chattel mortgage security is at present limited to loans made to an individual on the security of household property (as defined in the Bank Act), with the result that the banks are prohibited from taking such security either on a wider range of goods or in respect of manufacturers' and dealers' inventories. We recommend that the whole matter of existing limitations on the nature of specific security available to the banks should be thoroughly reviewed with a view to leaving the banks as free as possible to take such security as the requirements of individual situations might indicate. The result would, we suggest, be an appreciable and useful broadening of the banks' ability to serve the increasingly complex and changing requirements of the business community.

**Government Sponsored Lending Programs**

**136.** Specific acts of Parliament provide for bank loans to particular classes of borrowers on favourable terms. In each case the Government guarantees a percentage of the loans made by each chartered bank. Such loans make up about 4½ per cent of all general loans outstanding.

**137.** Farm improvement loans are granted under the Farm Improvement Loans Act and are guaranteed against loss up to an amount equal to 10 per cent of the aggregate principal amount made by the individual bank during each lending period of approximately three years. At December 31, 1961, the amount outstanding under the Act was $194 million. Throughout the period the rate that the chartered banks could charge for these loans was restricted to five per cent. Until April 1956 this was above the prime rate which up to then was 4½ per cent. From August 1956 to the present, however, the prime rate was above five per cent to that since then these loans have been available to farmers on especially favourable terms.

**138.** Prairie grain loans refer to special loans granted to western farmers under the Prairie Grain Producers Interim Financing Act of 1951 and of 1956, and under the Prairie Grain Loans Act of 1960. The first two acts were passed to assist farmers who were left with unthreshed grain in the fields by early falls of snow. There is no information readily available on the amount of loans granted under the first interim financing act but under the second a total of 23,234 loans were granted amounting to a total of $19,424,890. Under the Prairie Grain Loans Act only 64 loans were granted for a total of $34,210.

**139.** Fisheries improvement loans are granted under the Fisheries Improvement Loans Act which came into effect in December 1955. From January 1st, 1956, to March 31st, 1961, 795 loans amounting to $932,421 were made under this Act by the banks. Over the same period other lenders have made a total of 59 loans amounting to $117,470. Hence, the chartered banks have been by far the most active lenders under the Act, although, as the figures indicate, the demand has not been large. These loans are guaranteed up to 15 per cent of the aggregate principal amount of the first $500,000 lent by each bank, and 10 per cent of the excess over $500,000.

**140.** Business improvement loans are granted under the Small Businesses Loans Act which came into force on January 19, 1961. The purpose of the Act is to provide for intermediate and short-term credit, not exceeding $25,000, to the proprietors of manufacturing, wholesale trade, retail trade and service businesses having a gross annual revenue estimated not to exceed $250,000 for the improvement and modernization of equipment and premises as described in the Act. The bank is required to take security on the equipment or real or immovable property in respect of which the proceeds of the loan are to be expended, except where it is considered necessary or advisable to take other security. Loans made by all banks from inception on January 19, 1961, to the end of December, 1961, numbered 2,977 for a total amount of $25,582,000. These loans are guaranteed by the Government against loss to the extent of 10 per cent of the aggregate principal amount of loans made by each bank during the period ending December 31, 1963. In Quebec it is not possible to take security by way of chattel mortgage on movable equipment, the security primarily stipulated by regulation, and consequently loans for the purchase of such equipment have been limited to those cases where other acceptable security was obtainable.

**141.** Home improvement loans are granted under the National Housing Act for a very wide variety of home alterations and improvements. Losses are guaranteed under the National Housing Act up to five per cent of the aggregate principal amount loaned by each bank. From the beginning of the program in 1955 to the end of 1961, 206,767 loans were granted amounting to $237,982,000.

**142.** Veterans' loans were granted under the Veterans' Business and Professional

Loans Act. Lending under the Act came into force in January 1947 and reached a peak of over \$5 million in 1948. The amount outstanding since then has gradually declined to approximately \$200,000.

143. Loans to the Canadian Wheat Board to finance grain deliveries differ substantially from the loans made to individuals for capital purposes under the abovementioned acts; they carry a Government guarantee. Similarly, loans made for the purchase of Canada Savings Bonds are Government sponsored and free from risk. Adding these loan categories to guaranteed loans proper, their sum accounts for 8.3 per cent of total loans in 1961, almost unchanged from 8.1 per cent in 1954. However, if the substantial volume of insured N.H.A. mortgages granted by the banks is included, an entirely different picture is given of the extent to which the banks are supporting Government-sponsored projects. On this basis almost 21 per cent of the total of Canadian loans are now granted under a Government-sponsored program. The introduction of insured mortgages raised this percentage from 8.1 per cent in 1954 to its present high level. The recent introduction of business improvement loans will no doubt raise the percentage even higher.

**Financing Exports and Imports**

144. In the past few years international money markets have developed considerably and it has become steadily easier for exporters and importers in most parts of the world to choose to finance their transactions wherever interest rates are lowest. In the case of Canadian exporters and importers, once goods have left Canada or before they have entered this country, financing is sometimes arranged in London or New York. While the goods are in Canada the financing is usually done here and most of it is done by the chartered banks in the course of their normal business. The banker's functions in connection with foreign trade may be divided into two main sections. The first is the handling of foreign exchange; i.e. the banks provide the machinery by which the Canadian importer pays the foreign seller of the goods or the Canadian exporter receives payment for the goods he is sending abroad. The second main function is in facilitating the credit arrangements between buyer and seller, including the furnishing of credit reports, and the extension of bank credit or other means of financing the transaction.

145. The settlement of Canada's foreign trade transactions is usually handled through one of three principal methods:

1. Payment through open account
2. The use of Bills of Exchange
3. The use of Commercial Letters of Credit.

Where buyers and sellers have an inter-company relationship or are otherwise well and favourably known to each other, and where there are no serious exchange transfer difficulties, exports are often arranged on an open account basis. By this method the cost of goods exported is charged to the foreign importer's account on the books of the Canadian exporter, and settlement between them is made on the basis of private arrangements. The transactions are known as "clean payments," and a large volume of these payments is handled daily by Canadian banks on instructions from correspondent banks around the world.

146. A large and growing proportion of Canadian export trade is financed by means of sight or time drafts drawn on the foreign buyer. The export may be financed by discounting the relative bill of exchange with one of the chartered banks at the time of shipment. Alternatively, the bill is often left with the banks for collection through a foreign correspondent. Still another financing procedure is for the Canadian exporter to pledge the bills to his bank as partial or full security for a general line of credit. In the

latter case the bank will usually arrange for the collection of the bills and apply the proceeds against the exporter's loan.

**147.** On the import side the banks handle a large volume of bills of exchange drawn by foreign suppliers. The settlement of these items frequently requires short-term advances to the Canadian importer to bridge the time between his payment for the goods and his subsequent sale of the goods in Canada. A further portion of Canada's imports is financed through Commercial Letters of Credit issued by the chartered banks. These are issued in a wide variety of forms and their processing is a highly complex undertaking calling for specialized departments within the banks. The Canadian banks also act as agents for their correspondents abroad in the processing of foreign Letters of Credit covering Canadian exports.

**148.** The financing of Canadian external trade is not confined within the limits of actual export and import transactions but extends to cover the full period dating from domestic production operations to final settlement from foreign buyers, in the case of exports, and the time between the signing of a contract to purchase of foreign goods and their eventual disposal to the consuming public in Canada or elsewhere, in the case of imports. Frequently the complete cycle will be financed under an ordinary line of credit.

**149.** Where the nature of foreign trade transactions requires longer-term financing, one to five years, the banks may go to the Export Finance Corporation of Canada Limited. Under the Export Credits Insurance Act, Section 21A, the Government makes available facilities for the financing of transactions which may not fall within the scope of the activities of the Corporation, as for example when credit terms are longer than five years. The Corporation was established by the banks in April 1961 to provide new medium-term financing facilities for the purpose of assisting Canadian exporters to meet the credit terms offered in world markets by foreign suppliers. The basic principles in handling business put through the Export Finance Corporation of Canada Limited are:

(i) Each transaction must be covered by Export Credits Insurance.

(ii) Credit terms are not to be longer than five years.

(iii) The exporter will arrange the required financing through his own bank which, in turn, will have access to the rediscount facilities of Export Finance Corporation of Canada Limited.

The operating procedure of having exporters go through their own bank with this type of financing reduces handling routine and costs to a minimum. In effect, the banks do the work and thereby make it possible for the Corporation to function satisfactorily in modest quarters and with a small staff.

**150.** The Export Finance Corporation of Canada Limited is, in fact, a "rediscount bank" to which chartered banks turn over foreign trade obligations discounted by them for Canadian traders who have taken the bills in settlement for export sales. As the corporation progressively builds up its portfolio of bills, it will in turn raise funds against these assets by selling its own notes to the investing public. The underlying security for these note issues will be the Corporation's capital resources, the rediscounted trade paper with the obligation of the Canadian exporter and the foreign buyer, and any security the foreign buyer may have put up, as well as the protection of Export Credits Insurance. In addition, the trade paper will bear the "with recourse" endorsement of whatever chartered bank rediscounted it. With this underlying strength, the Corporation's issues will be a prime investment and it should be possible to acquire working funds through the investment market to an amount of several multiples of the Corporation's paid-up capital. The Corporation's rediscount rates must, of course, be determined by market conditions at the time of the respective transactions. In this connection, the broad operating objective is that all-in charges to the Canadian exporter should be on a scale that will enable him to compete effectively with the quotations of other international traders.

151. At the inception of the Corporation, it was expected there would be a substantial demand for money to finance the export of manufactured capital goods but, thus far, the volume of this business has been disappointingly small. However, some of the export business undertaken since these new financing facilities became available will not yet have reached the stage where term trade paper in settlement for the sales has been received and is available for rediscount. At the end of 1961, there is something less than $65 millions of rediscounts on the Corporation's books, a large part of which was either held by the banks prior to the setting up of the Corporation or relates to the export of commodities such as grain.

**Bankers' Acceptances**

152. In order to broaden and improve the facilities and operations of the money market in Canada the chartered banks have given very careful study to the creation of a market in bankers' acceptances. A detailed study of the techniques and procedures which relate to the bankers' acceptances market in both the United Kingdom and the United States led to the conclusion that neither system could, without considerable variation, readily be adapted to Canadian conditions. As a result bankers' acceptances in Canada will not follow either the New York or the London pattern. As far as possible bankers' acceptances will be drawn in connection with the financing of goods, wares and merchandise of a type described in Sections 18(1) (f) and (g) of the Bank of Canada Act, will be in large denominations and will be of a self-liquidating nature. It is as yet too early to determine the extent to which Canadian firms will find bankers' acceptances a convenient and suitable medium.

153. The money market dealers will act as principals to purchase and sell bankers' acceptances for their clients. The function of the chartered banks will be to assess the creditworthiness of the drawer of the acceptance draft and, if his is the primest credit, to accept such a draft and return it to the drawer. It is the drawer's responsibility to sell the accepted draft to a money market dealer. Bankers' acceptances will be eligible collateral as security for day-to-day loans in the money market and under Section 18(1) (b) of the Bank of Canada Act. The Bank of Canada has indicated its willingness to deal in bankers' acceptances which have a term to maturity of not more than 90 days. During the initial stages of the development of the acceptance market the chartered banks, in order to assess the usefulness of this new instrument in the market place outside the banking system will not themselves purchase acceptances for their own account. It has also been agreed that, after a period of six months from the beginning of the market in bankers' acceptances, the chartered banks will review the experience gained in that interval and make such changes in techniques and procedures as in the light of this experience are necessary or desirable.

## TABLE I

## STATISTICS RELATIVE TO SECTION 88 ADVANCES BY ALL BANKS IN CANADA

**Excluding Farm Improvement Loans and Fisheries Improvement Loans**

| Classification | Number of Borrowers | Authorized Credits | Outstanding Advances |
|---|---|---|---|
| | | $'000 | $'000 |
| 4(1) (b) **Agriculture** (Farmers) | 26,850 | 93,481 | 80,233 |
| 4(2) **Industry** | | | |
| (a) Chemical and Rubber Products | 151 | 37,815 | 20,027 |
| (b) Electrical apparatus and supplies | 97 | 56,783 | 35,908 |
| (c) Food, beverages and tobacco | 730 | 223,041 | 140,429 |
| (d) Forest Products | 1,607 | 211,912 | 123,183 |
| (e) Furniture | 245 | 19,339 | 14,175 |
| (f) Iron and Steel Products | 576 | 131,683 | 78,947 |
| (g) Mining and Mine Products | 269 | 68,134 | 40,303 |
| (h) Petroleum and Products | 35 | 11,255 | 2,280 |
| (i) Textiles, leather and clothing | 933 | 124,844 | 84,748 |
| (j) Transportation equipment | 59 | 16,924 | 7,679 |
| (k) Other Products | 403 | 36,765 | 25,789 |
| 4(5) **Grain Dealers and Exporters** | 170 | 364,991 | 173,516 |
| 4(7) **Merchandisers** (Wholesalers) | 764 | 146,308 | 88,448 |
| 4(8) **Other Businesses and Services** | 291 | 11,715 | 9,230 |
| | 33,180 | 1,554,990 | 924,895 |

Bank advances under the Farm Improvement Loans Act as at September 30th, 1961, totalled $199,300,000, and most of these loans would be supported by security provided under Section 88 of the Bank Act.

## TABLE II

### STATISTICS RELATIVE TO SECTION 86 ADVANCES BY ALL BANKS IN CANADA

| Classification | Number of Borrowers | Authorized Credits $'000 | Outstanding Advances $'000 |
|---|---|---|---|
| 4(1)(b) **Agriculture (Farmers)** | 22 | 207 | 154 |
| 4(2) **Industry** | | | |
| (a) Chemical and Rubber Products | 1 | 105 | 105 |
| (b) Electrical apparatus and supplies | 4 | 575 | 511 |
| (c) Food, beverages and tobacco | 55 | 36,202 | 21,900 |
| (d) Forest Products | 2 | 251 | 141 |
| (e) Furniture | 1 | 10 | 10 |
| (f) Iron and Steel Products | 6 | 1,186 | 1,056 |
| (g) Mining and Mine Products | 2 | 110 | 71 |
| (h) Petroleum and Products | | | |
| (i) Textiles, leather and clothing | 18 | 3,090 | 1,059 |
| (j) Transportation equipment | 3 | 137 | 39 |
| (k) Other Products | 3 | 61 | 57 |
| 4(5) **Grain Dealers and Exporters** | 50 | 177,485 | 46,884 |
| 4(7) **Merchandisers (Wholesalers)** | 161 | 22,114 | 13,256 |
| 4(8) **Other Businesses and Services** | 17 | 8,496 | 756 |
| | 345 | 250,029 | 85,999 |

## TABLE III

### STATISTICS RELATIVE TO SECTION 82 ADVANCES BY ALL BANKS IN CANADA

| | | | |
|---|---|---|---|
| 4 (h) Petroleum and Products | 114 | $73,672 | $48,929 |

## TABLE IV

### GENERAL LOANS OF THE CHARTERED BANKS UNDER PROGRAMS SPONSORED BY THE GOVERNMENT OF CANADA, MARCH 31, 1954-61

(millions of dollars)

| Types of Loans | 1954 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 |
|---|---|---|---|---|---|---|---|---|
| Farm Improvement Loans | 131.6 | 121.9 | 124.0 | 121.2 | 118.0 | 136.6 | 154.6 | 174.5 |
| Prairie Grain Loans[1] | * | * | .8 | .5 | .9 | .4 | .1 | * |
| Fisheries Improvement Loans | — | — | .1 | .2 | .2 | .3 | .3 | .4 |
| Business Improvement Loans | — | — | — | — | — | — | — | 1.9 |
| Home Improvement Loans | — | 1.7 | 25.8 | 39.4 | 47.6 | 60.0 | 55.5 | 56.1 |
| Veterans' Loans | 2.0 | 1.7 | 1.4 | 1.0 | .7 | .5 | .3 | .2 |
| Total General Loans Guaranteed | 133.6 | 125.3 | 152.1 | 162.3 | 169.2 | 197.8 | 210.8 | 233.1 |
| Total General Loans | 3,047.5 | 3,087.2 | 3,945.2 | 4,056.4 | 4,023.2 | 4,311.8 | 4,713.7 | 5,052.8 |
| Percentage of General Loans Guaranteed | 4.4% | 4.1% | 3.9% | 4.0% | 4.2% | 4.6% | 4.5% | 4.6% |

[1]Loans made under the Prairie Grain Producers Interim Financing Act of 1951 and of 1956, and under the Prairie Grain Loans Act of 1960.

*Less than $.05 million. —No loans made or outstanding.

SOURCES: Bank of Canada, *Statistical Summary*, July, 1961, and *Financial Supplement* 1958, and 1959; Department of Finance, *Public Accounts of Canada*, Vol. 1, Part 1, for the years 1954 to 1960, *Report of Operations of the Veterans' Business and Professional Loans Act*, 1954 and subsequent years, *Report on Operations under the Fisheries Improvement Loans Act*, 1957 and subsequent years, and other information supplied by the Department.

## TABLE V

### LOANS, MORTGAGES AND OTHER ADVANCES UNDER GOVERNMENT SPONSORED PROGRAMS OR GUARANTEES, MARCH 31, 1954-61

(millions of dollars)

| Loans & Insured Mortgages | 1954 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 |
|---|---|---|---|---|---|---|---|---|
| Guaranteed General Loans | 133.6 | 125.3 | 152.1 | 162.3 | 169.2 | 197.8 | 210.8 | 233.1 |
| Other Loans Guaranteed | | | | | | | | |
| Cdn. Wheat Board Loans[1] | 73.6 | 94.4 | 93.6 | 64.4 | 125.0 | 105.6 | 130.4 | 161.4 |
| C.S.B. Loans[2] | 109.0 | 98.0 | 114.0 | 115.0 | 116.0 | 111.0 | 127.0 | 127.0 |
| Total Guaranteed Loans | 316.2 | 317.7 | 359.7 | 341.7 | 408.4 | 414.4 | 468.2 | 521.5 |
| Insured Mortgages | — | 110.0 | 345.0 | 508.0 | 615.0 | 824.0 | 981.0 | 963.0 |
| Guaranteed Loans and Insured Mortgages | 316.2 | 427.7 | 704.7 | 849.7 | 1,023.4 | 1,238.4 | 1,449.2 | 1,484.5 |
| Total Loans in Cdn. currency and Insured Mortgages[3] | 3,902.0 | 3,984.0 | 5,248.0 | 5,708.0 | 5,737.0 | 6,305.0 | 6,937.0 | 7,223.0 |
| Percentage of Guaranteed Loans and Insured Mortgages in Total | 8.1% | 10.7% | 13.4% | 14.9% | 17.8% | 19.6% | 20.9% | 20.6% |

[1]Includes loans granted through the Wheat Board under the Prairie Grain Provisional Payments Act in 1960 and 1961, and under the Prairie Grain Advance Payments Act in the years 1958-61.

[2]Loans to finance the purchase of Canada Savings Bonds at time of issue.

[3]Exclude Canadian day-to-day and call loans.

SOURCES: Table 5; Bank of Canada, *Statistical Summary, Financial Supplement* 1957 to 1960, and July, 1961; Department of Finance, *Public Accounts of Canada*, Vol. 1, Part 1, various years; and *Canadian Credits*, The Royal Bank of Canada.

# SECTION IV

## DEPOSITS

154. Public attention is, perhaps, most often focussed on the loaning and investing aspects of banking. But the ability of the chartered banks to carry out their loaning functions adequately depends on the way in which they perform, or are permitted to perform, as deposit institutions. This section includes a detailed outline of bank policies and practices in connection with deposits.

155. The Canadian dollar deposits held by the chartered banks for selected years since 1930 are shown in Table I, with the percentage represented by each type of deposit in Table II. Deposits by governments and other banks are usually repayable on demand, so are those of corporations, individuals, etc., which are listed under the heading "Other Current." Personal chequing accounts, which were first made available in 1957, are also included in the figures for "Other Current."

### Deposits Repayable on Demand

156. Demand deposits, which now represent about 40 per cent of total Canadian deposits, perform two closely related roles in the economy. As well as representing a store of liquid assets, demand deposits are used as the chief medium of payment in Canada. Their predominance is indicated by Table III which, however, omits transactions in cash and orders on credit unions and trust companies and bank money orders for which no comparable figures are available.

### TABLE I

### CANADIAN DOLLAR DEPOSITS IN CHARTERED BANKS

(Millions of Dollars)

| At Dec. 31 | 1930 | 1935 | 1940 | 1945 | 1950 | 1955 | 1960 | 1961 |
|---|---|---|---|---|---|---|---|---|
| Govt. of Canada | 27 | 12 | 66 | 922 | 339 | 517 | 510 | 588 |
| Prov. Govt. | 21 | 41 | 67 | 91 | 161 | 181 | 119 | 134 |
| Other Banks | 13 | 14 | 13 | 19 | 117 | 139 | 201 | 216 |
| Other Current | 642 | 641 | 1,031 | 2,063 | 2,770 | 3,915 | 4,301 | 4,701 |
| Total Repayable on Demand | 703 | 708 | 1,177 | 3,095 | 3,387 | 4,752 | 5,131 | 5,639 |
| Personal Savings* } Other Notice* | 1,426 | 1,486 | 1,641 | 2,865 | 4,558 | | | |
| Personal Savings* | | | | | | 5,633 | 7,215 | 7,618 |
| Other Notice* | | | | | | 464 | 576 | 929 |
| Total | 2,128 | 2,194 | 2,818 | 5,960 | 7,945 | 10,848 | 12,922 | 14,186 |

*Before 1954 Personal Savings and Other Notice were shown together as "Other Notice."

SOURCE: *Canada Gazette.*

## TABLE II

## CANADIAN DOLLAR DEPOSITS IN CHARTERED BANKS

(Percentage of Total)

| At Dec. 31 | 1930 | 1935 | 1940 | 1945 | 1950 | 1955 | 1960 | 1961 |
|---|---|---|---|---|---|---|---|---|
| Govt. of Canada .... | 1.3 | 0.5 | 2.3 | 15.5 | 4.3 | 4.8 | 3.9 | 4.1 |
| Prov. Govt. ............ | 1.0 | 1.9 | 2.4 | 1.5 | 2.0 | 1.7 | 0.9 | 0.9 |
| Other Banks ............ | 0.6 | 0.6 | 0.5 | 0.3 | 1.5 | 1.3 | 1.6 | 1.5 |
| Other Current ........ | 30.2 | 29.2 | 36.6 | 34.6 | 34.9 | 36.1 | 33.3 | 33.1 |
| Total Repayable on Demand ........ | 33.0 | 32.3 | 41.8 | 51.9 | 42.6 | 43.8 | 39.7 | 39.8 |
| Personal Savings*.. | 67.0 | 67.7 | 58.2 | 48.1 | 57.4 | 51.9 | 55.8 | 53.7 |
| Other Notice* ...... | | | | | | 4.3 | 4.5 | 6.5 |
| Total................ | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

* Before 1954 Personal Savings and Other Notice were shown together as "Other Notice."

SOURCE: *Canada Gazette.*

## TABLE III

## PAYMENTS MADE BY SELECTED DEMAND INSTRUMENTS IN CANADA

(Millions of Dollars)

| Year | Post Office Money Orders[1] | Express Money Orders[2] | Federal Govt. Cheques[3] | Savings Cheques[4] | Current Cheques[4] Amount | Current Cheques[4] % of Total | Total |
|---|---|---|---|---|---|---|---|
| 1955 | 669 | 133 | 4,879 | 8,786 | 152,565 | 91.3 | 167,032 |
| 1956 | 704 | 134 | 5,278 | 9,733 | 182,557 | 92.0 | 198,406 |
| 1957 | 800 | 135 | 5,844 | 10,207 | 195,352 | 92.0 | 212,338 |
| 1958 | 846 | 133 | 6,313 | 10,581 | 217,592 | 92.4 | 235,465 |
| 1959 | 853 | 126 | 6,773 | 11,958 | 244,285 | 92.5 | 263,995 |
| 1960 | 869 | 118 | 7,062 | 11,840 | 265,970 | 91.2 | 285,859 |
| 1961 | n.a. | n.a. | 7,313 | 12,787 | 289,904 | | n.a. |

SOURCES:

[1]Dominion Bureau of Statistics, *Canada Year Book*, Annual.

[2]Dominion Bureau of Statistics, *Railway Express*, Annual.

[3]Canadian Bankers' Association.

[4]Dominion Bureau of Statistics, *Cheques Cashed in Clearing Centres*, Annual. See footnote in this section for coverage of these statistics.

TABLE IV

ANNUAL CHANGES IN
DEMAND DEPOSITS AND GROSS NATIONAL PRODUCT
CANADA - UNITED STATES COMPARISON

| | CANADA | | | | UNITED STATES | | | |
|---|---|---|---|---|---|---|---|---|
| | Demand Deposits | | | % Change in G.N.P. | Demand Deposits | | | % Change in G.N.P. |
| Year | Total* | Change | % Change | | Total** | Change | % Change | |
| | ($ Millions) | | | | ($ Billions) | | | |
| 1935 | 569 | | | | 22.1 | | | |
| 1940 | 875 | + 306 | + 53.8 | + 56.3 | 34.9 | + 12.8 | + 57.9 | + 38.8 |
| 1945 | 1,986 | +1,111 | +127.0 | + 75.5 | 75.9 | + 41.0 | +117.5 | +112.3 |
| 1946 | 2,155 | + 169 | + 8.5 | + 0.1 | 83.3 | + 7.4 | + 9.7 | − 1.4 |
| 1947 | 2,139 | − 16 | − 0.7 | + 11.1 | 87.1 | + 3.8 | + 4.6 | + 11.2 |
| 1948 | 2,259 | + 120 | + 5.6 | + 14.8 | 85.5 | − 1.6 | − 1.8 | + 10.7 |
| 1949 | 2,353 | + 94 | + 4.2 | + 8.1 | 85.8 | + 0.3 | + 0.4 | − 0.5 |
| 1950 | 2,563 | + 210 | + 8.9 | + 10.2 | 92.3 | + 6.5 | + 7.6 | + 10.3 |
| 1951 | 2,712 | + 149 | + 5.8 | + 17.6 | 98.1 | + 5.8 | + 6.3 | + 15.6 |
| 1952 | 2,932 | + 220 | + 8.1 | + 13.3 | 101.5 | + 3.4 | + 3.5 | + 5.5 |
| 1953 | 3,081 | + 149 | + 5.1 | + 4.3 | 102.5 | + 1.0 | + 1.0 | + 5.3 |
| 1954 | 3,165 | + 84 | + 2.7 | − 0.6 | 106.6 | + 4.1 | + 4.0 | − 0.6 |
| 1955 | 3,592 | + 427 | + 13.5 | + 9.1 | 109.9 | + 3.3 | + 3.1 | + 9.5 |
| 1956 | 3,725 | + 133 | + 3.7 | + 12.7 | 111.4 | + 1.5 | + 1.4 | + 5.5 |
| 1957 | 3,676 | − 49 | − 1.3 | + 4.3 | 110.3 | − 1.1 | − 1.0 | + 5.6 |
| 1958 | 4.041 | + 365 | + 9.9 | + 3.1 | 115.5 | + 5.2 | + 4.7 | + 0.4 |
| 1959 | 4,028 | − 13 | − 0.3 | + 5.7 | 115.4 | − 0.1 | − 0.1 | + 8.6 |
| 1960 | 3,930 | − 98 | − 2.4 | + 3.3 | 115.1 | − 0.3 | − 0.3 | + 4.5 |
| 1961 | 4,111 | + 181 | + 4.6 | + 2.5 | 119.9 | + 4.8 | + 4.2 | + 3.3 |
| 1961 / 1935 | | +3,542 | +622.4 | +753.8 | | + 97.8 | +442.9 | +619.2 |
| 1961 / 1950 | | +1,548 | + 60.4 | +104.6 | | + 27.6 | + 29.9 | + 83.2 |

*Average of month-end figures—Public demand deposits.

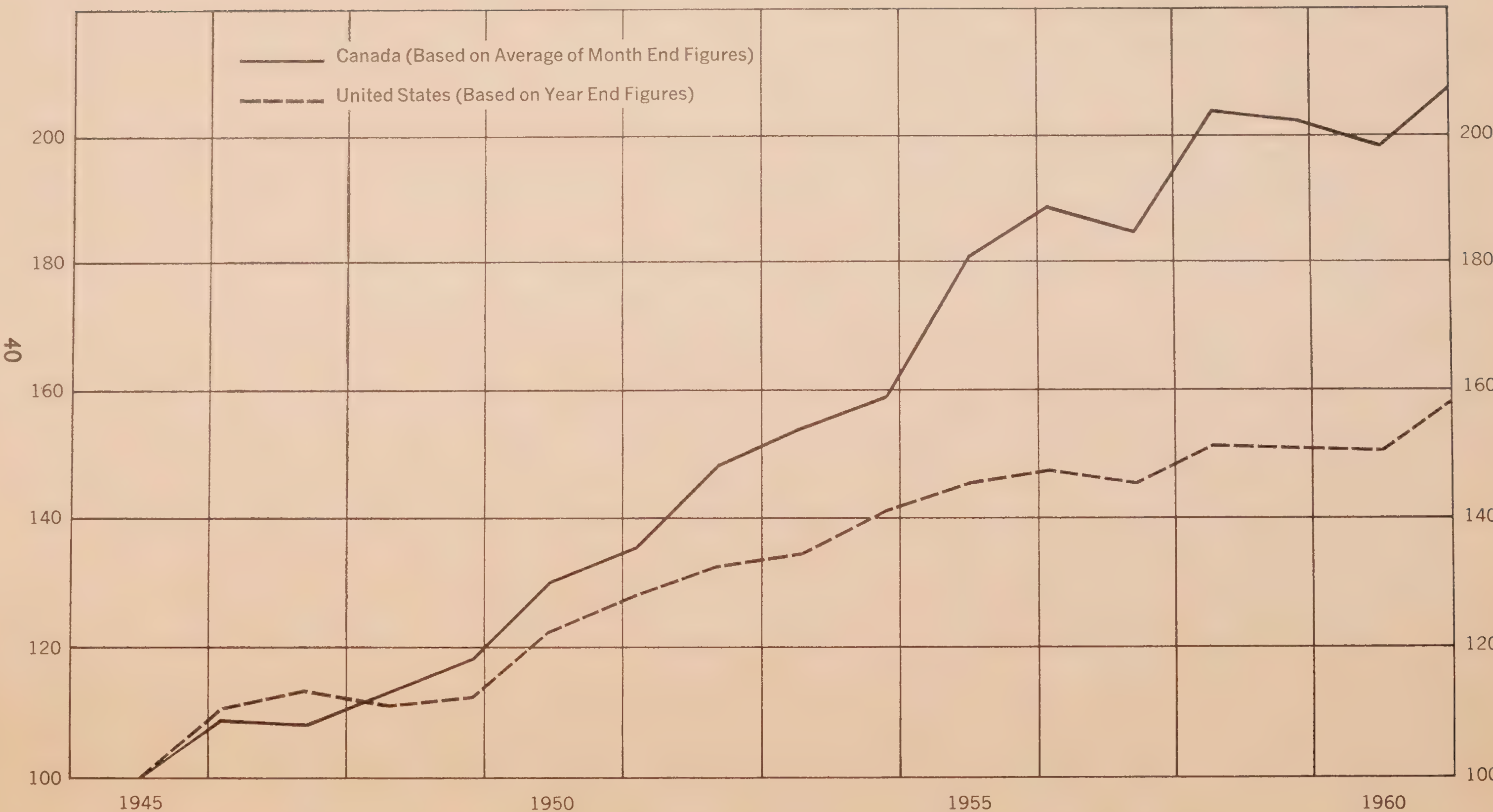
**Year-end figures.

Sources: Canada: Bank of Canada, *Statistical Summary*. United States: *Federal Reserve Bulletin*.

CHART I

INDEX OF DEMAND DEPOSITS

1945 = 100



## TABLE V

## VELOCITY OF DEPOSITS

| | Demand Deposits | | Notice Deposits | |
|---|---|---|---|---|
| | Velocity | Change | Velocity | Change |
| 1945 | 23.61 | | 1.25 | |
| 1946 | 23.05 | − .56 | 1.23 | − .02 |
| 1947 | 25.44 | +2.39 | 1.18 | − .05 |
| 1948 | 27.38 | +1.94 | 1.19 | + .01 |
| 1949 | 27.24 | − .14 | 1.16 | − .03 |
| 1950 | 29.97 | +2.73 | 1.27 | + .11 |
| 1951 | 33.89 | +3.92 | 1.37 | + .10 |
| 1952 | 36.46 | +2.57 | 1.35 | − .02 |
| 1953 | 37.33 | + .87 | 1.49 | + .14 |
| 1954 | 38.11 | + .78 | 1.45 | − .04 |
| 1955 | 38.53 | + .42 | 1.44 | − .01 |
| 1956 | 43.01 | +4.48 | 1.53 | + .09 |
| 1957 | 50.92 | +7.91 | 1.54 | + .01 |
| 1958 | 52.11 | +1.19 | 1.48 | − .06 |
| 1959 | 57.99 | +5.88 | 1.55 | + .07 |
| 1960 | 65.39 | +7.40 | 1.54 | − .01 |
| 1961 | 68.29 | +2.90 | 1.52 | − .02 |

NOTE: Velocity is the ratio of cheques cashed to average month-end deposits. Cheques cashed represent total debits in 35 centres 1945-1957, and in all clearing centres after 1957 (52 centres 1958-60; 51 in 1961).

SOURCE: D.B.S., *Cheques Cashed in Clearing Centres*, Annual.

**157.** The total of payments made by cheques on current accounts has risen much faster in recent years than the balances maintained in such accounts, which have risen from an annual month-end average of $569 million in 1935 to $4,111 million in 1961, an increase of 622 per cent. Although such deposits in Canada have increased faster than demand deposits in U.S. Commercial banks, as shown in Table IV and Chart I, the pattern of post-war growth in the two countries is similar. Canadian and United States demand deposits moved up or down in the same direction in all but two of the 15 years.

**158.** While demand deposits have not kept pace with the growth of Gross National Product, deposits in both countries expanded faster than output during the war years. Between 1940 and 1945 Canadian deposits rose 127 per cent while Gross National Product increased by only 75 per cent. Since monetary policy during this period was of necessity geared to an expansion of the money supply in order to facilitate the financing of the war effort deposits were permitted to increase sharply.

**159.** By the end of the war the money supply was at an unusually high level relative to G.N.P., and the rapid post-war growth in output occurred without a commensurate increase in demand deposits. Between 1945 and 1949 deposits increased by only 18 per cent while G.N.P. rose 38 per cent. During the 1950's there were alternate periods of monetary restraint and expansion; with restraint predominating. As a result, demand deposits increased by only 53 per cent between 1950 and 1960 while Gross National Product rose 100 per cent. Nor has the trend reversed in recent years. Since 1955 G.N.P. has risen 36 per cent but demand deposits only 14 per cent.

160. This restriction in the growth of demand deposits in relation to G.N.P. is illustrated in Chart II. The Chart further shows the generally contra-cyclical pattern of bank deposit growth. In 1947, for example, while G.N.P. rose 11 per cent, demand deposits dropped one per cent. In the 1951-52 Korean War period G.N.P. rose 33 per cent but demand deposits were restricted to a 14 per cent gain. Furthermore, in the 1956-57 recovery while G.N.P. rose 18 per cent demand deposits increased only two per cent. On the other hand, during the 1958 recession when G.N.P. rose only three per cent demand deposits were up ten per cent.

161. However, the volume of payments made through the banking system has continually increased during the post-war period as shown by bank debits. Thus, changes in what is customarily called the velocity of circulation[1] or the turnover of deposits have tended to compensate for changes in the quantity of money. Years of economic prosperity and credit restraint when deposits have been held down have been characterized by an accelerated rise in velocity. For instance, the turnover of demand deposits increased from some 38 times in 1955 to 51 times in 1957 as shown in Table V. In the post-war period turnover has risen in periods of prosperity as an increase in expenditures has swelled the volume of cheques drawn on demand deposits. In addition, there are other forces at work tending to increase velocity. During periods of tight money, the demand for liquidity in the form of deposits increases—hence its value rises. The resulting higher short-term interest rates attract relatively inactive balances into interest-earning media with the result that these balances are activated. Since 1954 a money market in Treasury bills, finance company paper and other paper has developed and, as well, there have been substantial sales of Canada Savings Bonds. These media serve to transfer funds from less active accounts to more active accounts thereby increasing over-all velocity.

162. In referring to a chartered bank deposit as less active it is not suggested that it was previously not being utilized in the economy. On the contrary, funds on deposit with the chartered banks are continuously employed in the banks' wide-ranging lending and investing activities. Neither is it suggested that these balances are lost to the banking system since the funds will be returned to the banks in the deposits of their new owners. However, when relatively inactive balances are invested in other interest-bearing media, the funds become available for a new series of transactions throughout the economy. Thus, while the volume of bank deposits remains unchanged, their velocity has been increased.

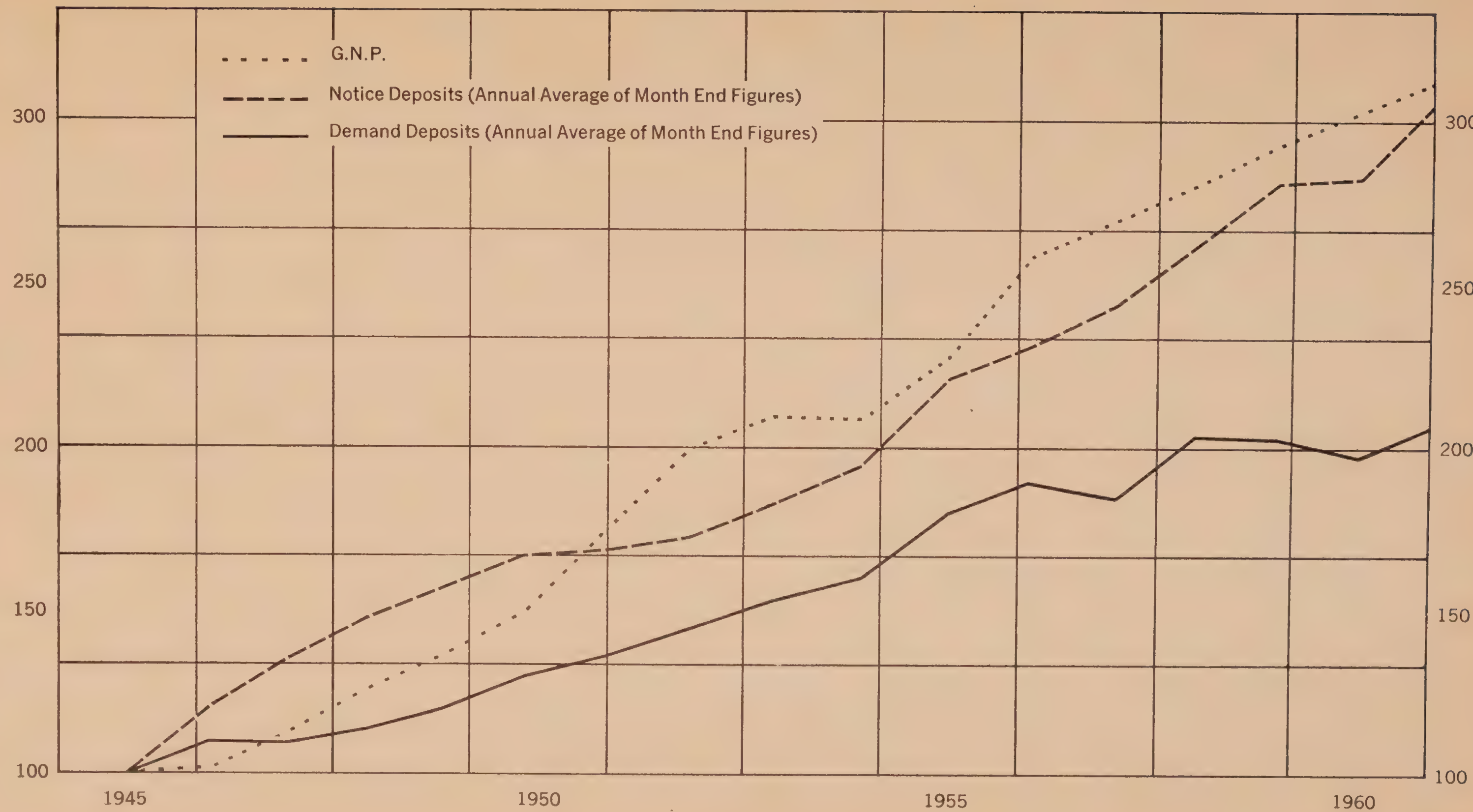
163. It may be of interest to note that velocity has been rising in other countries as it has in Canada. "Except for brief and mild declines during business contractions, the velocity of money in the United States (i.e., the ratio of the volume of expenditures to the stock of money) has increased steadily since the end of World War II. This is true for concepts of money that include and exclude time deposits and for such differing concepts of expenditures as total non-financial payments, debits to demand deposits, and

[1]The velocity of circulation is calculated by dividing total debits to individual accounts by an average of deposits. Since 1942 The Canadian Bankers' Association's monthly figures of total debits have been compiled to show separately the amount of debits to individual savings and current accounts in major clearing centres, and, in addition, since June 1957 separate figures have been compiled for personal chequing accounts. For these years, the approximate turnover of demand deposits may be calculated by dividing annual total debits to current accounts by the annual average of demand deposits. The resulting measure of turnover will be somewhat understated as the figures for debits were compiled for branches in only 35 centres prior to 1957 and 52 clearing centres since then. A survey conducted by The Canadian Bankers' Association in 1953 indicated the 35 centres provided 85 per cent coverage. It has been established by survey that the addition of all remaining clearing centres in 1957 has increased the coverage to approximately 90 per cent. However, the fact that the data are incomplete does not materially affect the resulting trend of turnover shown in Table V.

## CHART II

## INDICES OF DEPOSITS AND GROSS NATIONAL PRODUCT

1945 = 100



the several variants of national income. Furthermore, it is true for most other prosperous economies as well."[2]

164. The second function of demand deposits is that of a store of liquid assets. Liquidity is defined as the relative ease with which assets can be converted into money and thus, besides serving as a means both of collection and of payment, demand deposits are, along with cash, the public's most liquid resource. Many other liquidity media compete with demand deposits as a store of value. While in Canada savings deposits are subject to notice of withdrawal, they are in practice accorded chequing privileges. Other savings media vary in their liquidity. Some, such as deposits in competing savings institutions, may be subject to checquing privileges, although such deposits are not officially considered a part of the money supply. For many other instruments, however, it is necessary to arrange for their sale or redemption and conversion into money before the proceeds can be used as a means of payment. There is frequently the additional risk of a fluctuating value.

165. Nine out of ten cheques and money orders issued in Canada are deposited into current accounts. Part of the banks' function as a depository then is to obtain payment for such items. Banks give immediate credit even though the collection of items which appear on deposits may take some time to effect. (This statement does not apply to items of $50,000 and over, which are cleared by wire.) A depositor in Halifax depositing a cheque drawn on Vancouver, for example, gets immediate credit in his account, even though it may be some days before the cheque is charged to the maker's account in Vancouver. In the meantime, the bank has, in effect, financed the transaction. The cost of this float is heavy and the banks are constantly seeking ways to speed up the collection and clearing process by various means, including the increasing use of electronic equipment.

166. Although the banks do not pay interest on current account balances, if they permitted unlimited activity in the accounts without making a service charge, this could be considered a very high payment for the use of such funds. This was recognized by the Macmillan Report of 1933. As the report pointed out, if a charge were not made this "would result in the shifting of the costs of performing certain services from one class of customer to another class."[3]

167. While the operational procedures for personal chequing accounts vary widely between individual banks—some, for example, sell cheque books at 10¢ a cheque and return cancelled cheques to their customers while others subtract the service charge (at a rate of 10¢ per cheque) from the account and retain the cancelled cheques—the operation of a current account is basically the same in all banks. Current account customers receive a statement of account and cancelled cheques monthly and more often if required. Public acceptance of the personal chequing account is developing steadily but slowly. At December 31, 1961 the total amount outstanding in Personal Chequing Accounts was only $104 million or just over one per cent of total personal savings deposits.

168. Service charges are normally calculated by allowing one free entry per month for every $50 of minimum monthly credit balance. A charge of 10¢ is made for each additional debit and credit entry with a minimum monthly charge of $1.00. Where cheques are listed by the bank and charged to a customer's account in total, the charges

[2]Richard T. Selden "The Postwar Rise in the Velocity of Money," *The Journal of Finance*, December 1961, p. 483.

[3]Report of the Royal Commission on Banking and Currency in Canada, Ottawa, 1933, page 74.

are based on the number of individual cheques. In accounts which normally maintain balances of at least $2,000, but are subject occasionally to wide fluctuation, the allowance for free entries may be based on the average balance.

**169.** From time to time a bank will make a cost analysis of a customer's account and if it is evident that the service charge just described is inadequate in a particular case an additional amount is charged. It can be appreciated that current accounts vary so widely in the variety of services that may be provided that no single overall service charge can be applied to all customers of a bank. The question is further complicated by the permission granted to some important customers to issue their cheques as "Negotiable without charge at any branch in Canada, far northern branches excepted." Normally the remuneration given the banks for this par privilege is in the form of the maintenance of certain minimum deposit balances.

### Government of Canada Deposits

**170.** The deposits of the Federal Government are allocated between the banks on an agreed ratio according to each bank's share of the unrecovered costs of handling Federal Government business. Following an agreement reached in 1953 the banks have paid interest to the Government on some portion of these deposits. The present rate, negotiated in 1959, provides for interest at a rate of 10 per cent below the average rate on accepted tenders at the weekly auction of three-month Treasury bills. This is payable on the amount by which the Government's minimum weekly balance at all banks exceeds $100 million. It should be pointed out that the Government accepts no obligation to keep a minimum of $100 million or more on deposit.

**171.** Some idea of the scope and growth of Government business handled by the banks is given by the number of Government cheques and other instruments cashed (excluding those of the Unemployment Insurance Commission) in the years 1951 and 1961. In 1951 some 36.8 million cheques were negotiated; in 1961 this figure had risen to 62.1 million, almost nine per cent of all cheques handled by banks in Canada.

**172.** While remuneration for some special services is paid on a per-item service charge basis, free balances are maintained by the Government and to some extent these recompense the banks for the heavy routine cheque and deposit handling functions. The question of the adequacy of remuneration for services rendered the Government is a matter of continuing concern to the banks. As outlined above, while the banks pay interest on weekly balances in excess of $100 million, the Government is under no obligation to keep any free balances with the banks. In spite of repeated requests compensation has not been put on a properly defined basis and it is now considered very inadequate in relation to the sharp rise that has taken place in the volume of government business.

**173.** Under Section 93 (1) of the Bank Act, the banks have been prevented from making any charge in respect of cheques or other instruments drawn on or payable to the Government, and the Government has not agreed to provide adequate compensation. Indeed it may be said that this forms a special burden not encountered by other industries in doing business with the Federal Government. As pointed out in the paragraph previously quoted from the Macmillan Commission of 1933, this, in effect, means that charges to other customers of the banks must be sufficient to offset the expenses incurred in handling Federal Government entries.

**174.** A section, similar to s. 93 (1) of the present Act first appeared in the Bank Act of 1890. That the relation of the Government to the banks has vastly changed since then is illustrated in the following table.

## TABLE VI

## GROWTH OF FEDERAL GOVERNMENT IN RELATION TO THE BANKS

| | 1890 | 1961 | 1961÷1890 |
|---|---|---|---|
| | ($ Millions) | | (times) |
| Canadian Federal Govt. Budgetary Expenditures | 40 | 5,958 | 149 |
| Gross National Product | 803 | 36,844 | 46 |
| Canadian Dollar Deposits at Chartered Banks | 129 | 12,804 | 99 |
| Federal Government Bank Deposits | 3 | 257 | 86 |

SOURCES:

[1]Government Expenditures—Department of Finance, *Public Accounts of Canada*, for the fiscal year ended March 31, 1961.

[2]Gross National Product for 1890 estimated by O. J. Firestone *Canada's Economic Development 1867-1953;* for 1961, *D.B.S. National Accounts.*

[3]Federal Government Bank deposits—*Canada Gazette.*

175. Government budgetary expenditures in the 1961 fiscal year were almost 150 times the 1890 figure, a much faster growth than either Government bank deposits or G.N.P. Even the foregoing is not a full measure of the increased burden on the banks, however, because there have come into existence in the last 30 years Government policies involving various types of welfare payments effected by means of millions of small cheques or other instruments for such purposes as Unemployment Insurance benefits, Family Allowances, Old Age Pensions, and so on. As previously mentioned, the number of such items has almost doubled in the last decade alone. The physical burden of these millions of payments is both heavy and costly, and could hardly have been envisaged when the privilege of exemption from charges was first embodied in the Bank Act.

176. The chartered banks make a very substantial contribution to Government revenues by keeping eight per cent of their Canadian dollar deposits in Bank of Canada notes or in interest-free balances with the bank. During 1961 such notes and deposits averaged $983 million.

### Provincial Government Deposits

177. Provincial government deposits, unlike Federal deposits, have done no more than hold their own when compared with pre-war percentages. These deposit accounts operate in a similar manner to corporate current accounts but are separated on the banks' balance sheets for statistical purposes.

### Deposits of Other Banks

178. Depostis by other banks in Canadian currency are also shown separately, and mainly represent accounts maintained by foreign banks in Canada. They are used to provide cover for drawings on Canada by these banks and serve to facilitate the encashment of Canadian cheques in the United States and other countries. For example, cheques of Canadian drawers cashed in Kansas City would be cleared by the American bank to the Canadian correspondent who would credit the deposit account of the American bank with the proceeds. Canadian banks for similar reasons maintain reciprocal deposits with foreign banks. The growth of these deposits in Canada both in dollar amount and as a percentage of total Canadian dollar deposits is, in part, a reflection of the continued growth of Canada's foreign trade for which foreign banks have required larger deposits. Perhaps of some importance also, however, is the fact that Canadian banks are held in the highest regard in every part of the world as a safe depository. Part of the large growth in such deposits is, therefore, a reflection of the desire of foreign

banks to have some liquid resources in the safety of Canadian banks. Deposits in foreign currencies, including those by foreign banks, are discussed later in this brief.

**Personal Savings Accounts and Other Notice Deposits**

**179.** As is evident in Tables I and II some 60 per cent of total Canadian dollar deposits of the chartered banks are now in the form of personal savings accounts or other notice deposits. The chartered banks have long been the most important savings institutions in Canada and, at latest count on September 30, 1961, the banks had over 10.8 million personal savings accounts on their books.

**180.** In view of the extent to which savings deposits make possible the broad credit operations of the banks they must be considered fundamental to our financial system. By the same token, it is important that the banks continue to hold a major portion of the public's savings.

**181.** While demand deposits represent, in general, the "working capital" of individuals, organizations and companies, notice deposits are more likely to represent their reserves held pending a major expenditure or with investment in view, as a cushion in case of emergency, or simply the accumulation of savings built up over the years.

**182.** This distinction between demand and notice deposits is evidenced by the different rates of turnover for each type of account. From Table V it can be seen that the turnover of savings deposits in 1961 was 1.52 compared with a turnover of 68.29 for demand deposits.

**183.** The importance of savings accounts to the community arises not only through their role in facilitating savings but also in the uses to which the funds are put. The chartered banks play a vital part in our financial system as general credit institutions. Whereas other savings depositories tend to specialize in granting credit of certain types or for certain purposes, the chartered banks make their depositors' funds available to nearly all classes of borrowers to meet a great variety of credit needs. Consequently, they are able to direct savings into many channels to meet varying demands, and can shift easily and quickly from one use to another as demand warrants. This function is facilitated in Canada through the flexibility of the branch banking system by which funds may be made available in any part of the country as the changing seasons and the varying needs of industry demand.

**184.** Chart II reveals the uninterrupted increase in notice deposits during the post-war period. It also shows that while their growth has been generally upward the rate of increase has varied in a contra-cyclical manner in much the same way and for similar reasons as earlier noted in the case of demand deposits.

**185.** However, during the 25-year period 1935-1960 Gross National Product has increased by 733 per cent, considerably in excess of the increase of 433 per cent in notice deposits. Only during the immediate post-war period 1945-1950 did the percentage increase in deposits exceed that of G.N.P.

**186.** This disparity is not a reflection of a lower propensity to save on the part of Canadians. Indeed, if the savings in credit unions and Canada Savings Bonds are added to those in chartered banks the increase in savings so defined over the 25-year period amounts to 739 per cent. Rather, the disparity between the growth of savings in chartered banks and G.N.P. is a reflection of the increasing importance of other avenues of savings.

**187.** The growth in chartered bank notice deposits has been encouraged by the increase in the number of branches operated by the chartered banks. The increased from 3,448 branches and agencies in Canada and Newfoundland in 1935 to 5,225 at the end of 1961, while the number of savings accounts has more than doubled. On October 31, 1935, the number of these accounts in chartered banks stood at 4.0 million; by September 30, 1961, this figure had increased to 10.8 million. That the increase in number of

branches has enabled the banks to reach a wider proportion of the population can be seen from comparing the growth in the number of accounts, 170 per cent, with the growth in the population over the same period of only 68 per cent.

**188.** Two other significant trends in savings deposits may be noted. First, the average size of individual savings accounts has shown a fairly consistent increase from $365 in 1935 to $711 in 1961. Second, in keeping with this trend, the proportion of individual accounts of under $1,000 has shown a steady decline from 92.6 per cent of the total number of accounts in 1935 to 83.8 per cent in 1961.

**189.** In deciding how and where to hold his savings, an individual will normally be governed by the following five considerations:

1. The safety of his funds;
2. The readiness with which his savings can be converted back into cash;
3. The rate of interest or other return received;
4. The ease and convenience of making the necessary transactions;
5. Other services offered in conjunction with the savings facilities.

**190.** The safety of deposits in Canadian chartered banks is today generally unquestioned. While there is no system of deposit insurance comparable with that in the United States, the present strength of the Canadian banks almost precludes the possibility of failure. In addition, the chartered banks are held by tradition, by legislation and by sound management to high standards of prudence in their handling of funds entrusted to them—standards which are much stricter than those applied by some competing savings institutions. Consequently, there have been no losses to savings depositors of Canadian chartered banks for more than 35 years, including the years of depression in the thirties. Also, of course, savings deposits are not subject to the risk of market price fluctuations, as are corporate securities and marketable government bonds.

**191.** While in general banks reserve the right to demand notice of withdrawal on savings accounts, it has not been the practice to require it. Bank savings deposits therefore are akin to currency in terms of their liquidity and consequently are an attractive form of saving. In addition, the savings customers of the chartered banks enjoy at a price full chequing privileges which enable them to make payments to third parties freely.

**192.** The convenience of savings deposits is enhanced by the widespread network of branches and sub-agencies of the chartered banks. Most Canadian towns and neighbourhoods have a branch or sub-agency of at least one of the chartered banks. The branch banking system makes possible the operation of branches in areas which could not support a comparable independent savings institution because branch banking operates most economically.

**193.** The branch system of banking also enables the banks to offer all their savings customers, regardless of location, a wide variety of other services. These include: chequing accounts, credit facilities, safekeeping services, security transactions, foreign exchange, financial information and counselling, and contracts with financial centres throughout the world.

**194.** The present rate of interest paid on savings accounts is 2¾ per cent calculated on the minimum quarterly balance and paid half-yearly on the last day of April and October. Service charges are calculated quarterly with one free cheque allowed for each $100 of the minimum quarterly balance and a charge of 15¢ is made for each additional cheque.

**195.** Several of the banks have operated "Christmas Clubs" savings accounts. Another has provided a life-insured savings plan. No statistics for evaluating the acceptance of these special types of deposits are available from the individual banks for obvious competitive reasons.

### Savings Deposits — Chequing Privileges

**196.** The practice of permitting customers to issue cheques against savings accounts, which is not customary in either the U.S. or the U.K., appears to have had its origin in the competition between Canadian banks early in the present century. The practice has disadvantages for the chartered banks as it materially increases the costs of operation of their savings departments. It was this fact that encouraged the banks to introduce the Personal Chequing Account in 1957. It was felt that if savings accounts with high activity could be handled in a group with simplified procedures and not interspersed among less active savings accounts, handling costs could be considerably reduced and part of the saving passed on to the customer in lower service charges.

**197.** However, the privilege is issuing cheques on savings accounts has been widely used by the public. It provides for the banks' customers a higher degree of liquidity and convenience in the use of their accounts than they would obtain if the practice were discontinued. As mentioned, these two factors of liquidity and convenience, are important in the public's choice of where it will hold its savings.

### Other Notice Deposits

**198.** The category of other notice deposits includes the savings deposits of institutions and corporations which are maintained, charged service charges, and paid interest in exactly the same way and at the same rates as are Personal Savings Deposits.

**199.** With the rise in yields obtainable on Government Treasury bills in the 1950's corporate treasurers began to invest surplus working funds, most of which had been held in bank current accounts, in interest-earning securities. At first the investments were mainly in Treasury bills and finance company paper. Later, as the market developed, investments were also made in repurchase agreements with and day-to-day loans to investment dealers and to large organizations such as grain companies, large retail and chain stores, and some provincial and municipal governments. To meet this competition and to avoid having to force their own customers to deal elsewhere the banks developed short-term interest-bearing deposit instruments of their own. These include fixed-term deposit receipts for larger amounts, terms for which were revised in 1961. Receipts are issued for deposits of $25,000 and over, left for terms of 30 to 364 days. The rates are revised periodically in reflection of money-market conditions; at the time of writing they run from $3\frac{1}{8}$ per cent for 30 to 59 days, to $3\frac{7}{8}$ per cent for 270 to 364 days. Receipts are not negotiable and the deposits may be withdrawn before the agreed term but with an interest penalty. Although fixed-term deposit receipts account for slightly less than one per cent of personal savings deposits they are a very significant factor in the other notice deposits of the banks which have increased substantially since the new rates were introduced.

**200.** In addition, one of the chartered banks in 1960 began issuing term notes with maturities of from one to six years. These notes are issued in amounts of $10,000 and up and are negotiable. The rates are set from time to time; at present they run from four per cent for notes under two years, to five per cent for notes with a maturity of between five and six years.

### Deposit Insurance

**201.** In contrast to the situation in Canada where there is no deposit insurance, perhaps the most striking feature of U.S. regulations for the safety of depositors is the deposit insurance provided under the Banking Act of 1933, which established the Federal Deposit Insurance Corporation (F.D.I.C.). Out of a total of 13,999 banks in the United States at the end of 1960, 13,451 participated in the insurance scheme. At that date the deposit insurance fund amounted to $2.2 billion, or 0.85 per cent of total deposits in insured banks. Participating banks must insure the deposits of each of their

customers up to a maximum of $10,000 by paying an annual premium to the Corporation of 1/12 per cent of their total deposits. A portion of this premium is returned to the banks each year after allowing for payment of losses and expenses of the Corporation.

202. In the unit banking system of the United States, the F.D.I.C. is a valuable guarantor of safety to the vast majority of depositors who keep their money in the numerous small banks throughout the country. This deposit insurance system promotes safety in two ways:

(1) It stands ready in emergency to protect depositors and maintain confidence in the banking system; and

(2) It requires its many policy-holding banks to observe certain standards of safety, thus raising the average stability and safety of the whole group.

203. However, the situation in Canada is quite different. Each of the Canadian banks is large enough and strong enough to stand alone without deposit insurance and we see no need for the introduction of insurance.

### The Segregation of Deposits by Term or Type

204. There are a number of considerations involved in any proposal to differentiate among types of deposits in the chartered banks for reserve or lending purposes. Not only are there implications for monetary control and asset management but also the repercussions of any proposed changes in the public's attitude to and confidence in Canadian banking are of fundamental importance.

205. As noted in Table V the velocity of circulation of current account deposits is much higher than for savings accounts. It is on the fundamental facts of the greater stability and lower velocity of notice deposits that suggestions have been made from time to time that the chartered banks might quite properly engage in a much larger way in long-term financing, including conventional mortgages. It has been suggested that one way of doing this would be to "notionally segregate" term deposits from current deposits for long-term lending purposes.

206. However, this would introduce an unnecessary rigidity into the structure, as there need be no formal link between the term of deposits and the term of loans. From the community's point of view the over-all problem is to achieve a balance in the total supply of and demand for financial resources. It has been the function of financial organizations, especially the banks, to receive the savings and working capital of the community for varying terms and to apportion them as loans or investments at short or long term as circumstances warrant.

207. Within the over-all pattern there are specialized intermediaries, but the banks are the logical institutions to undertake the key role in the allocation of credit. On the one hand the banks' deposit obligations are a ready substitute for currency and are universally acceptable. On the other hand they lend to the widest variety of borrowers and in the most varied ways. Moreover, in the case of bank loans to other intermediaries, the banks to some extent are lenders of last resort.

208. On a number of occasions the Bank of Canada has moved to influence the investing policies of the chartered banks. On one occasion in the early post-war period there was a limitation on the amount of Government of Canada bonds banks could hold and the amount they could earn on these bonds. More recently the situation has been completely opposite and the Bank of Canada has insisted, in connection with the 15 per cent liquidity ratio, that a minimum investment must be maintained in the form of Treasury bills and day-to-day loans.

209. It might be considered that one way to encourage increased investment by the banks in longer-term instruments would be to permit a lower cash reserve against savings accounts. In the United States there are lower cash reserve requirements for the savings deposits of the commercial banks than for demand deposits. The difficulty with this is

that cyclical and other shifts between demand and time deposits create complications for monetary control. The whole problem of cash reserves has been discussed earlier in the brief and it is perhaps sufficient to say here that it is hardly satisfactory for a situation to exist that could work in the opposite direction to the policy of the central bank.

**210.** There is, however, another aspect of the general problem of longer-term lending by the chartered banks that also concerns the central bank. Canadian banks have for many years been relatively immune from a liquidity crisis such as developed in the United States in the 1930's. In large measure this has been the result of asset management policies that kept adequate reserves for any foreseeable emergency or period of contraction. Nevertheless, it is one of the prime functions of a central bank to act as the lender of last resort to the banking system. If the Canadian chartered banks enter more heavily into longer-term investments, it would appear logical that the Bank of Canada be prepared to accept for rediscount some of the longer-term instruments that would be acquired by the banks in the process and for longer rediscount periods than would be now possible.

**211.** In summary, we are opposed to any attempt to segregate deposits by term or type because be believe the result would be to introduce undesirable rigidities into the financial system.

## SECTION V

## FOREIGN CURRENCY BUSINESS

### The Foreign Exchange Market

**212.** The active participation of Canadian chartered banks in foreign currency operations of all sorts is a natural corollary of the great importance to Canada of foreign trade. If Canadian banks were not in a position to provide the whole range of banking services necessary for carrying on an extensive export and import trade, Canadians requiring these services would have to obtain them from foreign bankers, and this would have a considerable adverse effect on our current account balance of payments. To the extent that Canadian banks are able to go beyond providing such services to Canadians and are able to compete successfully with foreign banks for further international business, there is an additional favourable impact on our balance of payments. Revenue from banking services is, in short, a significant item in the balance of payments, and the success of Canadian banks in the intensive competition with foreign bankers is important to Canada in the same way as success in holding and extending our export markets generally.

**213.** The foreign currency business of the banks arises out of all transactions with foreign countries, such as imports, exports, investment of all kinds, payment for services, interest, dividends, profits, remittances, gifts, tourism, etc. Foreign currency transactions include all types of transfers, cheques, drafts, currency, bills of exchange, and so on. Bankers' commercial letters of credit are also used extensively to ensure prompt payment according to specified terms.

**214.** In obtaining payment for exports, settlement may be taken in the currency of the country of the importer, provided the currency is reliably convertible and there is an adequate forward market; otherwise it may be in the interests of both buyer and seller to negotiate for payments in a key currency such as U.S. dollars, which also offers the advantage, if financing is required, of extensive credit facilities at low rates of interest.

**215.** The Canadian banks provide a wide variety of methods of payment for imports. Both the Canadian importer and the foreign exporter can have their interests

safeguarded by employing a Canadian bank commercial letter of credit, the terms of which can be made to suit the requirements of a particular transaction.

216. Banks in Canada are active in the forward markets for the key currencies, U.S. dollars and sterling, and for all the other free currencies for which there is a forward market. Any foreign currency that enjoys a forward market against one of the key currencies can, of course, be traded forward in Canada with the same facility. Forward trading in U.S. dollars and sterling is active up to six months, while less active trading takes place beyond six months up to a year. Any forward trading beyond one year would be subject to negotiation. Ordinarily the forward rates bear a close relationship to the difference in short-term interest rates between the countries concerned. Other factors, such as commercial supply and demand or the predominance of speculative pressure due to fears of devaluation or revaluation may affect the rates and ability to trade forward freely on a reasonable basis. Forward facilities enable exporters, importers and others to fix their exchange commitments. Banks may grant customers optional periods within which they may make delivery or take delivery of foreign currencies under forward contracts relating to trade and payment for services. Forward trading between banks is for fixed dates only. In granting customers optional delivery periods, banks' forward positions often become temporarily distorted through the exercise of these options. The handling of these operations requires the use or availability of substantial capital.

217. The handling of the foreign exchange business of the chartered banks is centred in the International or Foreign Exchange Departments of the individual banks where specially trained staff are in charge of the trading. These departments maintain contact with each other through foreign exchange brokers employed on a salary basis by The Canadian Bankers' Association. This Canadian foreign exchange brokerage procedure, introduced in 1950, has proved highly successful, resulting in greater activity and narrower spreads between buying and selling rates.

218. The individual trading departments of all banks also maintain constant touch with other foreign exchange markets in New York, London and continental Europe through private telephone and telex services, public telex and fast cable and telegraph connections. Foreign exchange operations are facilitated by the foreign agencies of the Canadian banks located in New York, London and elsewhere, which are in constant communication with their local markets. Other New York and London banks, as well as the large European foreign exchange trading banks, also are in direct telephone or telex communication with the foreign exchange trading departments of the Canadian banks, which, in turn, have ready access to the Canadian foreign exchange market on the basis of the special brokerage arrangement referred to above.

219. The foreign exchange trading departments of the banks maintain constant contact with their central branches across Canada, furnishing the latter by wire or telephone with particulars of the latest foreign exchange quotations. These central branches in turn keep in touch with any branches having any special interest in a particular currency for account of interested customers. Under this system all branches can offer their customers the facilities available in the largest foreign exchange trading centres at a minimum of cost, whether these requirements relate to transactions for spot or forward delivery. This organization is also available for the gathering and dissemination of special information relating to the latest developments affecting foreign exchange rates, foreign exchange regulations in countries operating under foreign exchange control, and any other information of interest to importers and exporters and others in Canada interested in international financial transactions.

**Foreign Deposits**

220. In recent years banking has been taking on an increasingly international

flavour, involving short-term deposits denominated mainly in United States dollars but also including sterling and some other currencies. Canadian banks have always accepted United States dollar deposits for the convenience of customers wishing to hold their balances in this way; the principal users have been Canadian exporters, Canadian companies operating plants in the United States, and customers requiring a depository for investment capital awaiting exchange into Canadian dollars or repatriation to the United States. However, banks in many European and other countries also accept deposits and make loans denominated in U.S. dollars or sterling, which have come to be known as Euro-dollar and Euro-sterling transactions. There are similar but less-well-known external markets in other currencies as well.

**221.** International differentials in interest rates are a factor in the spread of such practices. Thus, for example, the deposit interest rates offered by U.S. banks have for some time been lower than comparable rates in most other countries, with the result that holders of dollar balances, whether residents or non-residents of the U.S.A., have been able to obtain higher interest rates by directly or indirectly lending such balances to borrowers abroad. Until recently the relatively low level of deposit interest rates at U.S. banks was usually attributed to the maximums set for member banks of the Federal Reserve System under Regulation Q. While these maximum rates have recently been liberalized, the deposit rates of U.S. banks have not uniformly risen to the full amount now permissible and in many cases remain below comparable rates abroad.

**222.** Other factors are also involved, however, including the widespread demand for sterling and dollars as key currencies in world trade, the return of more normal foreign currency trading conditions following the war, the building up of official foreign exchange reserves by the principal trading countries, and the convertibility of major currencies on non-resident account. Speculation on exchange movements has also been a factor at times. U.S. dollars, external sterling and certain other currencies are free of all foreign exchange controls, and in the case of the United States dollar such funds have been readily available in large amounts at relatively low rates of interest. Sterling and the principal European currencies have the further advantage of being free of U.S. foreign assets control regulations.

**223.** Euro-dollar and Euro-sterling funds are highly volatile and, therefore, are commonly employed in call and other short-term loans and investments such as Treasury bills, short-term Government bonds, U.S. dollar finance company and commercial company short-term paper, and other first-class short-term investments, including the short-term financing of external trade. In some cases these funds are used in countries outside the United States and United Kingdom on a swap basis.

**224.** The growth of foreign currency deposits on the books of the Canadian banks since 1958 has been substantial, much of it on a fixed-term basis. At the beginning of that year they were a little over $1.8 billion but now amount to nearly $3.5 billion. This growth, of course, has not been confined to Canadian banks, since institutions in other countries have been aggressively competing for such deposits and the volume of transactions in international centres, especially London, has been impressive.

**225.** The success of the Canadian banks in this field is undoubtedly due to their reputation as depositories having regard to their own sound financial positions, their location and the relative political and economic stability of the country, as well as to the competitive rates of interest which they are able to offer. The volume is not entirely due to rates of interest, as many depositors prefer to use Canadian banks because of fear of international disturbances, blockage of funds and other considerations.

**226.** It may be noted that the acceptance of U.S. dollar deposits by non-U.S. banks is very similar to the flow of funds into U.S. non-bank financial intermediaries, insofar as the effects on the U.S. economy and the U.S. banking system are concerned. When a U.S. dollar deposit is made in a foreign bank the foreign bank simply acquires a claim

against (i.e. a deposit in) some particular U.S. bank, just as a U.S. savings and loan association or other domestic savings institution does when a deposit is made in it. The foreign bank may then lend or invest these funds, just as a domestic savings institution would do but this merely transfers the existing deposit to a third party. The U.S. money supply is not affected one way or the other, though the velocity of circulation is increased. Corresponding domestic effects may be ascribed to transactions in Euro-sterling or in any other currency for which there is a significant external market of this kind.

227. Canadian funds, of course, may flow into foreign banks in the same way as foreign deposits come into Canadian banks, depending on interest rates and the level of premium or discount on Canadian funds for forward delivery. In addition, non-resident banks seeking short-term funds compete in Canada for Canadian dollar deposits with the Canadian banks, trust companies, or other short-term borrowers such as the finance companies, etc. When interest rates abroad, after swapping costs, produce yields higher than in Canada, such Canadian funds may find their way into the United States dollar or sterling fixed-term deposits, or other forms of investment expressed in those currencies. This situation is subject to constant change depending on the factors referred to above. In general, deposit liabilities are offset by assets in the same currency, hence the risks of an exchange position are avoided.

228. This whole process is part of the mechanism of adjustment which keeps international interest rates in line. Hence, from the point of view of Canada as a whole, the net result of the competition of Canadian banks in this field has been a contribution towards stabilizing our balance of payments position on current account.

229. The following statistics show the comparative growth of Canadian dollar deposits and foreign currency deposits of the chartered banks during the period 1954-1961:

**CHARTERED BANK DEPOSITS**

($ Millions)

| As at Dec. 31 | Canadian | Foreign Currency | | |
|---|---|---|---|---|
| | | Banks | Others | Total |
| 1954 | 9,683 | 82 | 948 | 1,030 |
| 1955 | 10,848 | 106 | 950 | 1,056 |
| 1956 | 11,162 | 234 | 1,135 | 1,369 |
| 1957 | 11,407 | 270 | 1,557 | 1,827 |
| 1958 | 12,690 | 427 | 1,649 | 2,076 |
| 1959 | 12,279 | 530 | 1,842 | 2,372 |
| 1960 | 12,922 | 647 | 2,007 | 2,654 |
| 1961 | 14,186 | 703 | 2,785 | 3,488 |

Foreign currency deposits of the chartered banks show a more rapid rise than Canadian dollar deposits during this period of greatest growth. There is no detailed tabulation available of the ownership of these foreign currency deposits. However, in addition to the deposits of U.S. and other origin already mentioned, some Canadian funds have been swapped into U.S. dollars for short-term investment. The last mentioned transactions developed in part because of intense competition within Canada between banks, trust companies, investment dealers and finance companies for deposits, and in part because of competition from certain foreign banks active in the international money markets who were prepared to offer this facility to Canadian depositors. Deposit and lending rates are quoted between banks operating in this field of activity at very narrow spreads allowing little margin for losses, commissions or costs.

230. In the matter of reserve requirements on foreign currency deposits lodged with banks here, the following should be considered:

(a) Large cash reserves are already carried as deposits with other prime banks.

(b) Banks in most other countries competing for foreign currency deposits are not restricted by reserve requirements. Any restrictions, penalties, or conditions placed on Canadian banks and not similarly placed on foreign branches of American banks, banks in London, and on the Continent would unduly handicap the Canadian banks in this business.

(c) These funds are substantially invested on a short-term basis; a heavy percentage is always invested in Treasury bills, and call loans against bills and securities represent a further substantial percentage.

(d) The swapping of Canadian funds to U.S. dollars and sterling for short-term investment is relatively unimportant, considering that there is also a reverse flow of funds into Canada on the same basis. In any event, swap rates in addition to interest rates have a restrictive effect on the amount of funds that can be shifted from one currency to another on a swap basis.

# SECTION VI

## BANKS IN THE SECURITIES BUSINESS

231. The discussion of the short-term money market in later pages indicates the active and continuous participation of the banks in the Canadian securities market for their own accounts. The diverse nature of these activities keeps the banks constantly in touch with market conditions over almost the entire field of securities.

232. The banks maintain active trading desks in their head offices, and they also conduct trading operations in their main city offices across the country. At head office, the trading desk is used to implement decisions relative to the management of the banks' cash reserves—making and calling day-to-day loans and buying and selling Treasury bills and other securities. In order to keep abreast of day-to-day markets, the banks conduct trading with the investment dealers and brokers. The "street" market is also used to buy and sell securities to meet the requirements of customers.

233. In addition to the investment transactions carried on through their trading desks, banks have two other important operating functions in this field: the underwriting and retail distribution of securities.

### Underwriting

234. The economic development of Canada depends on a continuing expenditure by provinces, municipalities (and related public bodies), and corporations, on capital assets such as roads, bridges, pipelines, schools, utilities, factories, equipment, etc.

235. In the initial stages of such projects, the accepted procedure is for established sponsors of such undertakings to obtain short-term loans from banks. At a later stage the capital asset requires long-term capital financing usually of a term that will correspond roughly to the life of the asset, e.g., municipal local improvements are usually financed for a term of ten years by serial debentures maturing one to ten years, whereas financing of schools, sewers, and utilities tends more toward a twenty-year term or longer. In the transition from short-term bank loans to long-term capital financing, the banks are particularly able to provide an effective liaison.

236. The interest of the banks in the financial affairs of their customers stems from the knowledge that sound financial management contributes materially to the growth, development, and well-being of the customers. Therefore, the banks continue to give

full consideration to the customers' best interests as financing moves from short-term bank loans to longer-term capital requirements in the market place. It is the banks, therefore, which, in many such transactions, prove to be the most effective liaison in completing the successful transition from temporary to long-term financing. Consideration must be given to the ways and means of most satisfactorily obtaining capital and this involves the tailoring of capital issues in a fashion that will ensure the successful placement of issues in the market place where the issuer (seller) is desirous of incurring the lowest possible interest cost and the lender (buyer) anxious to obtain the highest possible interest return.

237. A balance between these two extremes can only be achieved by bringing to the market place issues which are properly conceived as to:

(a) *time of issuance*—when the market will be receptive to issues properly designed as set forth below:

(b) *term of maturity*—consideration must be given to market preferences for short-term or long-term issues and also to the term most desirable to the issuer;

(c) *coupon rates* which will attract investors with current buying interest;

(d) *long-range considerations* such as the need for further financing, so that recourse to the market will not be delayed in such a fashion as to create a major pile-up of accumulated financing. Regular, orderly financing will familiarize the market with the borrower and avoid the need to do too much financing at times when money is tight and expensive;

(e) *pricing* in a manner that is equitable for both borrower and lender.

238. The banks make their advice available to customers contemplating public financing and their experience in the securities markets equips them well to perform the task. Frequently a bank will participate in the underwriting of high grade security issues and for this purpose will associate only with experienced and reputable partners in an underwriting syndicate. In their respective syndicates, the banks assume a share of the liability and also share proportionately in the net profit or loss resulting from the undertaking. It should be noted that the banks work in partnership with investment dealers in underwriting issues except on occasions where the amount involved is less than $50,000 or the term is short.

239. If the offering prices of the securities are sufficiently attractive relative to the demand for their available resources, the chartered banks may purchase securities of appropriate term for their own account from the successful syndicate at the offered price. The successful syndicate looks to the bank or banks, if any, in that syndicate to finance the carrying, pending sale, of any balance remaining unsold at delivery date; there are no known instances where such assistance has not been forthcoming. This is a particularly useful service in the not infrequent periods of market "indigestion."

240. There has been some criticism from time to time, by some investment dealers, of bank participation in underwriting ventures. On examination, the details of such criticism do not seem to be valid. Some investment dealers appear to have the view that, inasmuch as the number of syndicates wishing to bid is frequently greater than the number of banks which are interested, some dealers or syndicates are, accordingly, penalized, and it is suggested that the banks should, therefore, withdraw completely from the underwriting of securities. A variation of the same argument is that the syndicate containing the borrower's banker or bankers has an unfair advantage in competitive bidding in that the banker will support only his own syndicate.

241. This criticism is not valid. Any lack of buying interest exhibited by the borrower's banker in particular, or by the banks in general, when an issue is re-offered for sale by another syndicate, is based on the offering price, and alternative opportunities for the utilization of available resources. To exclude the banks from the originating syndicates would not solve this problem. Competing dealers would undoubtedly try to

obtain orders in advance from the bank or banks that were considered likely to be interested.

242. As an indication of the important role banks play in this field, several of the largest borrowers in Canada, who sell their issues by private negotiation with a syndicate, have requested that a bank (or banks) be included in the negotiations in order to obtain the benefit of the banks' views in conjunction with those of the investment dealers.

**Retail Distribution**

243. A very important role is performed by the chartered banks in effecting a low cost, efficient, and widespread distribution of securities throughout Canada. A complete securities service is available to customers at even the smallest branches. In the major financial centres most of the banks have specialized staff and facilities through which customer transactions are channelled.

244. The banks do not consider it their function to "give advice on the stock market" but do accept orders from customers. Such orders to buy and sell stocks are routed from all branches to central points where the execution of the orders is handled by stock brokers. The banks usually make a handling charge for ensuring the safe delivery of securities.

245. The handling of customers' orders for bonds and debentures is somewhat more complex than for stocks; while the procedures vary in certain minor respects from bank to bank, the following outline is typical of most banks. Each branch is provided with a bulletin listing current bid and asked prices on all or nearly all Government of Canada market issues and certain provincial, municipal, and corporate bonds, for which an active market exists. Within certain limits as to amounts, all branches are authorized to effect transactions on the basis of the bulletin prices. Bulletins are revised and distributed to branches as frequently as market changes occur. Because the distribution of bulletins is usually from a number of central points, perhaps as many as seven or ten, the information and up-to-date service is usually available in even remote areas in less than two days after the change in either market prices or availability of issues.

246. In the case of bonds sold to customers at the bulletin prices, the branches requisition delivery through the central points. On the other hand, bonds purchased from customers are shipped periodically by branches to the central points. In either case, and particularly in the latter, some time elapses before the central points at which market trading occurs are aware of the extent to which their position may be affected by the volume of customers' bond transactions in process.

247. This float of transactions, which can at times be very large in total (even though the individual transactions are small), is carried by the banks without compensation other than accrued interest. The market risks that can evolve during the period of the float are absorbed by the banks, and if market prices move sharply in either direction the banks can lose because of the time lag; periods of substantial customer buying are often accompanied by rising prices, and bonds will be sold to branch customers several days before the central points are aware of the magnitude of the purchases they are required to make to cover the position, whereas weak markets are usually typified by substantial selling and declining prices, and bonds acquired by branches from customers do not reach the central point where they are to be sold for even longer periods.

248. In the case of any transaction, and of enquiries relating thereto, no branch is further removed from the market place than local telegraph or telephone facilities. The central points are well equipped to handle communications and transactions relative to all sorts of market activities.

249. In the field of retail distribution, the banks play a particularly valuable role in facilitating the sale of new issues to many interested investors over a very wide area. The vast branch network permits distribution to investors in communities where other reliable

means are either non-existent or not as conveniently available. While such communities obviously include those far removed from financial centres the service is equally valuable from the viewpoint of customers' convenience in residential, industrial, commercial and financial areas of the large metropolitan centres. In order to assist customers with the investment of their funds, branches are kept informed by bulletin or by periodic notification by mail, telephone or telegram, of a wide variety of issues both outstanding and new.

250. Widespread retail distribution of new issues is also facilitated by banks' participation in syndicates. Through their branch networks the banks can distribute securities by filling orders from customers in localities where it would not be practical for an investment dealer to have a representative. As a service to small buyers it has frequently happened that banks have sold bonds to their customers in outlying areas at issue prices for as long as a week to ten days after the market moved to a premium, retaining bonds until such time as the customer with funds for investment has had notice, by newspaper advertisement or otherwise, of the availability of the issue. Under these conditions, the position of the small investor is not prejudiced by immediate action of the large sophisticated investor who is in constant touch with market offerings.

251. A notable example of the important role played by the banks in the field of distribution of securities is apparent in the annual sale of Canada Savings Bonds. The banks' sales to customers represent 2/3 to 3/4 of the total issued. In addition, the banks handle a large volume of payroll savings plans and servicing of investment dealers' sales.

## SECTION VII

## MISCELLANEOUS SERVICES

252. Apart from the principal services which the chartered banks perform for their customers in the way of making loans, conducting deposit accounts, buying and selling foreign exchange, they also provide a wide variety of other services, some of which are discussed in the following paragraphs. For many of these services the banks usually receive commissions, fees or rentals, although a number of them are provided free as a service to their customers or to the community.

253. The chartered banks also provide a fast and efficient system of remitting funds to almost any part of the country by means of mail or telegraphic transfers. In addition they issue a large volume of drafts and money orders which provide for their customers a convenient form of making payments to third parties. Drafts and money orders are also issued in foreign currencies and are readily negotiable in almost any part of the world.

254. For persons travelling either in Canada or in foreign countries the banks provide a safe, convenient method of carrying funds in the form of travellers' cheques or travellers' letters of credit.

255. As more and more Canadians have acquired the habit of investing part of their savings in securities there has been a growing demand for safekeeping facilities. To meet this demand the chartered banks offer two kinds of services. They accept securities and other articles of value for safekeeping in their vaults, and in most branches they have installed safety deposit boxes for the use of their customers. In the case of securities left with them for safekeeping, the banks will collect the revenue as it becomes due and credit it to the customer's account. For customers who accumulate receipts outside normal banking hours, night depository facilities are provided.

256. The chartered banks accept payments of accounts such as light and gas bills, telephone bills, and municipal taxes, and these amounts are remitted to the principals or credited to their accounts. The banks lend their support to various charitable organiza-

tions by agreeing to receive and remit donations during fund-raising campaigns. Customers of the banks may also arrange to have regular remittances for rent, mortgage payments, insurance premiums, etc., charged to their accounts and sent to third parties. Other customers arrange to have their payrolls made up in pay envelopes by their bank, or paid in the banking office or credited to employees' accounts.

**257.** The collection of bills of exchange and promissory notes for their commercial customers has traditionally been an important function of the chartered banks. With the decline in the use of the bill of exchange as a means of settlement this function has diminished somewhat in recent years. Nevertheless, the number of such items being collected through the banking system is still large.

**258.** The chartered banks frequently act as agents for their customers in purchasing or selling stocks and bonds, arranging transfers, and deliveries to third parties, and exchanging interim certificates for definitive certificates or bonds. In this respect, the banks are not attempting to compete with regular dealers in securities but are merely providing a service to many of their customers, especially those who reside in the smaller centres.

**259.** During the two world wars the banks gave their support to the various Victory Loan campaigns, and since 1946 they have been active in promoting the sale of Canada Savings Bonds. The banks arrange for the issue of these bonds for cash, on monthly savings plans operated by the banks, or through employers on payroll deduction plans. They also register the bonds and are prepared to redeem them at any time on behalf of the Bank of Canada.

**260.** In recent years the growing use of credit both by businesses and by individuals has increased the need for reliable credit information. It is customary for people seeking credit to give the name of their bank as a reference and for those giving credit to seek credit information through the banks. Recognizing the unique relationship that exists between the bank and its customers, the banks are particularly careful to use the utmost discretion in the handling of credit enquiries, and the preparation of credit reports is invariably entrusted to senior personnel in the branches.

**261.** The chartered banks are frequently called upon by their customers and people abroad to provide information on particular industries, areas, or business conditions in general. To meet this demand the banks maintain research and business development departments, and publish a wide variety of pamphlets and booklets on topics of interest to businessmen. Most of the banks also publish monthly letters. For many corporations and municipalities the banks act as consultants on financial matters. They also act as redemption agents for the payment of their bonds, coupons and dividends.

**262.** In a smaller, but no less important way, the managers of the banks' branches serve their customers by providing advice and information on many day-to-day financial and business problems.

**263.** In addition to providing their customers with foreign exchange and the machinery through which foreign payments are made and financing the flow of goods between Canada and other countries the chartered banks also provide a variety of services to exporters and importers. This includes up-to-date information on foreign exchange regulations abroad.

**264.** An important consideration for Canadian exporters is the credit standing of their foreign customers. The chartered banks, through the use of a network of foreign agencies and correspondents located in all parts of the world, are able to obtain reliable credit information for their customers. Frequently, chartered banks will be asked by foreign companies or by their bankers to suggest the names of Canadian dealers who could handle their products. On the other hand, Canadian exporters frequently ask their bankers to obtain, through their foreign correspondents, the names of brokers or dealers abroad who might prove a satisfactory medium for selling their products.

265. Representatives of the foreign departments of the chartered banks travel abroad frequently to develop new businesses and to gather information which may be of use to the banks' clients in Canada. During these visits abroad contacts are established with prominent bankers and businessmen in the countries visited, and the benefit of this liaison is made available to importers and exporters in Canada.

# SECTION VIII

## INSPECTION

266. An important feature of the operations of the chartered banks and one which distinguishes them sharply from competing financial institutions is the existence of rigorous inspection procedures. These procedures are both internal, provided by the banks themselves, and external, provided by the shareholders' auditors and the Inspector General of Banks.

267. The practice of internal inspection by banks is one of long standing, and important benefits in control and efficiency are derived from the procedures which have been developed through many years of experience. Each branch and some departments of the bank are inspected annually on a surprise basis. This involves verification and evaluation of asset and liabilities in these units, including assessment of loan risks and critical examination of collateral security. Application of official rules and instructions is checked and any irregularities of consequence are reported to head office. In addition it is the duty of inspecting officers to observe and advise on branch operating efficiency and, among other things, to ensure that policies formulated at the executive level are carried out in all branches. Inspecting officers are attached either to district administrative departments or to head office. However, they report directly to head office and are expected to be as objective as possible in their appraisals.

268. Section 61 of the Bank Act requires the shareholders at each annual meeting to appoint two qualified auditors, whose duties include reporting to the president and the general manager concerning any transactions or conditions that, in their opinion, require rectification; any such reports must be submitted to the next meeting of the directors. The auditors must also report to the shareholders at the next annual meeting on the statement of bank assets and liabilities.

269. The duties of the Inspector General of Banks as provided in section 63 of the Bank Act are briefly:

(1) to satisfy himself that provisions of the Bank Act for the safety of creditors and the shareholders are being observed and that the bank is in sound financial position and to report the results of his examinations and findings to the Minister, and

(2) to certify to the Minister that the returns relating to cash reserves are correct.

270. The periodic inspection by the Inspector General supplements the internal inspections conducted by the banks.

271. It would not in our view be desirable for the Inspector General of Banks to become an officer of the Bank of Canada. We suggest that the Bank of Canada and the Inspector General must function independently if each is to perform a proper function. Occasions will inevitably arise when it is helpful for the Inspector General to be able to take an independent and objective position.

## SECTION IX

## PERSONNEL POLICIES

### Recruitment

272. There is an ever-present need for the best type of man and woman available. Banks generally recruit their employees direct from schools and universities. Branch managers keep in touch with local school principals, vocational guidance teachers, and others, looking for capable young people. Bank representatives also visit various universities and colleges to recruit members of graduating classes.

273. Educational requirements are now higher than at any time in the past. Increasing mechanization is opening the way for more interesting and challenging jobs, requiring more maturity and judgment on the part of the staff. There is a considerable turnover of personnel, particularly among the women as a result of marriage and family responsibilities. All these things combine to bring relatively rapid advancement, and put a premium on high initial educational qualifications and training. With few exceptions, banks nowadays want people with at least junior matriculation standing, and are hiring more and more university-trained people.

### Salaries

274. Salaries and benefits paid by the banks are fully competitive in the labour market. For the majority of employees the time worked is normally less than 40 hours per week, and overtime is paid thereafter at the rate of time and a half. In most banks it is the practice to grant general year-end bonuses.

### Female Staff

275. Approximately 55 per cent of the staff of the chartered banks today is made up of women. The turnover due to marriage and other factors is substantial, as already mentioned, and this restricts the numbers who are able to acquire the broad experience needed for senior posts. Nevertheless there are excellent opportunities for advancement for those "career minded" women who do remain on the staff, and many bank women today occupy positions of considerable responsibility.

276. Women hold a number of senior positions in head offices, some being for example members of the inspection staffs. Some women are branch managers, others are in charge of sub-branches, and still others are accountants, assistant accountants, or heads of departments. Opportunities for qualified women in the banks are expected to grow steadily in the future, so that the outlook for them is likely to be increasingly bright in the years ahead.

277. A survey at October 31, 1961 showed the following staff distribution in Canada:

| | Men | Women | Total |
|---|---|---|---|
| Salaried Staff | 27,846 | 36,511 | 64,357 |
| Wage Earners | 3,383 | 1,768 | 5,151 |
| | 31,229 | 38,279 | 69,508 |

### Training and Promotion

278. Almost invariably the chartered banks follow the practice of promotion from within, right up to the highest executive levels. Practically the only exceptions are for personnel having specialized professional training, for example in law, accounting, or economics, and internal promotion is followed wherever possible even in these fields. Officers at all levels are expected to be on the lookout for able individuals who are

capable of added responsibility and training, and such people are given every possible opportunity to broaden their experience.

279. Formerly it was customary to train bank staff entirely within the branch. This practical training was supplemented only by inter-branch transfers which widened the experience of new employees. These methods are still used, but it is no longer possible to rely on them entirely. The demands of modern procedures and the need for trained personnel to staff rapidly expanding operations are too great to be met in this time-consuming way. New staff members now usually get a period of intensive schooling in bank procedures at or soon after recruitment. Later they may be given additional training courses to prepare them for increased responsibilities right up to the level of branch management as they receive promotion or are being prepared for promotion. A new employee with advanced educational standing is likely to get special training in the form of rotation to a variety of duties in a relatively short period of time, and to move quickly to a position of responsibility.

280. The employees of all banks are encouraged to participate in the Fellows Course in Banking, which is offered through arrangements between The Canadian Bankers' Association and Queen's University, Kingston, Ontario; successful candidates generally have their tuition fees refunded and also receive a cash award. In some cases officers are selected to attend business administration courses at certain universities, the tuition fees and expenses being paid by their employers. Most banks maintain libraries for the use of their employees.

281. The selection of branch managers is based on performance. Subsequent training normally includes transfers to other branches in order to provide a variety of banking experience. There may also be included a period of credit or inspection work at head office or at a regional administrative office. Promotion is on merit, and normally evolves through successive transfers to branches entailing greater and greater responsibilities.

282. Intermediate and senior posts at head office and at regional administrative offices are filled in essentially the same way. In part this is accomplished automatically through the process of rotating branch personnel as part of normal training procedures, in part by the selection of those with particular aptitudes for specialized posts in regional and head offices. In either case promotion is on the basis of merit.

### Pensions and Other Benefits

283. The chartered banks offer various employee benefits, at least equivalent to those offered by other enlightened employers. Indeed, this is a field in which the banks have done much pioneering over the years. All banks operate retirement plans which make adequate provision for all long-service employees, male and female, and for those unfortunate enough to become incapacitated for further duty. Sick leave provision, Group Life Insurance and Group Health Plans are all on an unusually broad and generous scale.

# SECTION X

# BANK MECHANIZATION

### Meeting the Demands for Service

284. Two major forces have dominated Canadian banking in the post-war period: the increasing use of banking services, and the competitive drive for greater efficiency in banking operations. Between 1945 and 1961 Gross National Product more than tripled, but bank clearings quadrupled. In 1961 the number of deposit accounts increased by 568,000—an average of 2,370 every banking day. Cheques cashed (debits) in the 51 clearing house centres rose about $25 billion over 1960, to approximately $300 billion.

In a typical month some 57,800,000 debit entries were made to deposit accounts, compared to 53,200,000 in 1960.

**285.** Under the pressure of increasing activity the number of bank branches rose to 5,225 at the end of 1961, an increase of 174 in the year and 2,119 since 1945; bank employment reached 68,128 at the end of the respective fiscal years in 1961, compared with 66,796 a year earlier and 32,337 in 1945. Up-to-the-minute manually-operated mechanical aids have been installed to assist the staff. In large centres the required sorting, listing, balancing, distributing, and other processes involved in the clearing of cheques are already a twenty-four-hour operation involving batteries of manually-operated machines each capable of handling one thousand items or more an hour. Nevertheless, these methods have serious limitations in giving the customers the prompt and accurate service that is appropriate to today's high-speed communications. In spite of continually increasing staff it is becoming more difficult to keep up with the volume of work and to maintain the necessary degree of accuracy by existing methods.

**286.** The next step in the continuous drive of the chartered banks to maintain high standards of service to their customers is the use of electronic equipment. This will assist in the rapid and accurate processing of the continually growing volume of transactions. It will relieve personnel of the bulk of the monotonous routine work, and free them for the multitude of more interesting and challenging jobs that require human judgment and cannot be done by machines.

### Mechanized Cheque-Sorting

**287.** In working towards the introduction of electronic equipment, the emphasis so far has been on machines to "read" and sort cheques. For the past several years a special committee of The Canadian Bankers' Association has been studying various methods and systems. A wide variety of "languages" for automatic cheque-sorting was considered—punched-card systems, optical scanning, fluorescent ink, magnetic ink in code patterns, to give a few examples. After careful study the banks have agreed on the "Magnetic Ink Character Recognition" method, which has also been adopted by American and British banks. One reason for this choice is its readability; it can be read electronically through over-stamping, pencil and ink marks, oils, greases, carbon smudges, opaque tapes, etc. It is also extremely durable.

**288.** The banks have agreed in addition that, if maximum usefulness is to be achieved from electronic cheque-handling, there should be standards set for the size of cheques. They have adopted the same type-font as American and British banks (technically known as E-13B), and have agreed on the arrangement and the location of the message that the machines will read.

**289.** The cheque-reading machines will be worth while only at high-volume points such as main branches in larger clearing centres and other large branches. Most of the physical handling of items for clearing to other banks or branches is done within the individual bank, not in the clearing house itself, hence it is not essential for all chartered banks to inaugurate automatic cheque-sorting simultaneously. Nevertheless the maximum benefits will only be achieved when all are making use of the new procedure.

**290.** After electronic cheque-sorting is in full operation, it will be logical to tie it in with electronic bookkeeping. However, that is still some time in the future. In any case the introduction of electronic equipment is merely one more step in the evolution of banking in Canada which has been going on over the years. It will be necessary in order to maintain the high standards of service, speed and efficiency that Canadians have come to expect from their banking system.

### Other Countries

**291.** In other countries the order in which electronic procedures have been intro-

duced has tended to be the reverse of that in Canada—they have generally been applied to bookkeeping first and to cheque-handling second.

292. In the U.S.A. a number of banks began experimenting several years ago with the use of computers for handling various types of records. Some have now been successfully using them for some time; this includes the system used in California by the Bank of America, which is of particular interest because branch banking in that state is parallel to Canadian practice. British experience is of interest for the same reason; there the first computer was ordered in August 1959, without waiting for the perfection of mechanical cheque-handling procedures; the installation was designed to be fed by data derived from manual processes. A number of machines are available, differing considerably in detail, but they are all general-purpose computers taken from production lines rather than specialized machines designed for banking operations.

293. Many of the larger banks in the U.S.A. have a sufficient volume of business in a single office to justify the cost of a computer, but some employ one for central bookkeeping on behalf of a number of branches. A number of data processing centres are now springing up to provide smaller banks with similar facilities on a fee basis; some are run by large banks, others by computer manufacturers. In Britain a few of the larger bank branches also have enough volume to support a computer for their own work alone. In other cases, however, centralized bookkeeping is used for a number of branches, with entries transferred between the branches and the centre by telecommunications.

294. The mechanical handling of cheques — reading, sorting, and listing — is already widespread in the U.S.A. A rapidly increasing portion of all cheques handled by the clearing service of the Federal Reserve Banks is in the new coded form. In Britain experiments with a cheque-sorter using the E-13B type-font had been begun by one bank in the spring of 1960, eight months before the decision to standardize on that system, and equipment of this type is now being introduced.

## SECTION XI

## DIRECTORS

295. At the close of 1961 the chartered banks had a total of 253 directors. As might be expected, these directors have business activities encompassing the entire field of Canadian industry and commerce and have a wide knowledge of conditions in all parts of the country.

296. Directors are elected by the shareholders at their annual meetings with interim appointments made by the boards to fill vacancies which occur during the year. The usual practice at the annual meetings is for the shareholders to propose a slate of existing directors plus the names of other individuals who it is felt would make valuable additions.

297. In choosing a bank director there are many desirable qualities to be sought. The candidate should, of course, have sound judgment and undoubted integrity and be a success in his chosen field, for a director's name must add to the public's confidence in the bank. He should also have broad business experience, usually including an intimate understanding of a particular industry, because the bank's activities are diverse, entering into almost all fields of endeavour in the economy. Not the least of the qualities sought in a director is his ability to attract new and desirable business and to assist in retaining the goodwill of existing customers.

298. Bank boards generally meet weekly or bi-weekly. Some of the banks follow the practice of holding occasional meetings of their directors at points other than the city where their chief executive office is located. In addition, there are often local committees of directors in various provinces and these local committees meet from time to

time, as frequently as weekly, to discuss regional problems and to make recommendations in respect to the local operations of their bank.

**299.** In their deliberations the directors attempt to ensure that the bank follows sound policies. The board does not usually initiate policy—but no major policy decisions are made without the approval of the directors. More specifically, the typical board of directors authorizes the larger loans, appoints the chief executive officers of the bank and defines their duties, reviews branch inspection reports and ensures that full audits are carried out, approves dividend, capital and reserve policies and authorizes branch extension plans and other matters of major concern to the bank.

**300.** It is sometimes suggested that bank directors are in a position to steer bank credit to their own advantage and to the disadvantage of competitors. The duties and responsibilities of directors are set out in the Bank Act. Section 75 (3) provides:

> A director of the bank shall not be present or vote at a meeting of the board during the time at the meeting when a loan or advance to himself or a firm of which he is a member or a corporation of which he is a director is under consideration, unless the loan or advance is to a corporation controlled by the bank, all the issued capital stock of which, except the qualifying shares of directors, is owned by the bank.

**301.** In addition, loans to firms with which a bank director is associated are subject to regulations which do not apply in other cases. For instance, s. 75 (2) (f) provides that a bank may not, directly or indirectly

> lend money or make advances in a principal amount exceeding five per cent of its paid-up capital to a director of the bank or to any firm or corporation of which a director or the general manager of the bank is a member or shareholder without the consent of two-thirds of the directors present at a regular meeting of the board or a meeting of the board specially called for the purpose.

**302.** Section 21 of the Bank Act provides the following in respect to qualifications of bank directors:

> (1) A person is not eligible to be a director unless he holds stock of the bank as the absolute and sole owner thereof in his individual right and not as trustee or in the right of another, on which not less than
>
> (a) three thousand dollars, or such greater amount as the by-laws require, have been paid up, when the paid-up capital stock of the bank is one million dollars or less,
>
> (b) four thousand dollars, or such greater amount as the by-laws require, have been paid up, when the paid-up capital stock of the bank is over one million dollars and does not exceed three million dollars, or
>
> (c) five thousand dollars, or such greater amount as the by-laws require, have been paid up when the paid-up capital stock of the bank exceeds three million dollars;
>
> except that in the case of not more than one-quarter of the number of directors the minimum requirements of subscriptions to stock in paragraphs (a), (b) and (c) shall be reduced to fifteen hundred dollars, two thousand dollars, and twenty-five hundred dollars respectively.
>
> (2) A majority of the directors shall be subjects of Her Majesty ordinarily resident in Canada.
>
> (3) The election or appointment of any person as a director is void if the composition of the board of directors would as a result thereof fail to comply with subsection (2).
>
> (4) A person is not eligible to be elected or appointed a director after the first day of July 1959, if he has reached the age of seventy-five years.

# SECTION XII

## REVENUES, EXPENSES, NET EARNINGS, CAPITALIZATION, AND INNER RESERVES

### Revenues of the Chartered Banks

**303.** The chartered banks' revenues are derived principally from two main sources: from interest on the use of their financial assets—loans, securities, etc.—and from charges made to customers for services rendered.

304. It will be seen from Tables I and II, which trace the growth of bank earnings in the post-war years, that total gross revenues have increased over five-fold since 1945 and, in addition, there have been significant changes in the relative importance of the major sources of earnings. In the following paragraphs occasional reference is made to comparable earnings and expense experience in the U.S. banks. No similar information is available for U.K. banks either individually or in total.

305. Interest and discount on loans, which have increased nine times in the post-war period, accounted for 61 per cent of total bank operating earnings in 1961 compared with 35 per cent in 1945. The main reason for this shift in the source of bank earnings is to be found in the changing pattern of asset distribution. At the end of the war 72.2 per cent of the chartered banks' earning assets were invested in securities, principally Government of Canada bonds used to finance the war effort, while loans accounted for only 27.8 per cent of such assets. By 1961, however, this distribution had been reversed and loans accounted for 64.3 per cent of earning assets while securities made up only 35.7 per cent.

## TABLE I

### CANADIAN CHARTERED BANKS EARNINGS AND EXPENSES

| | 1945 | 1950 | 1955 | 1960 | 1961 | 1961÷1945 —times— |
|---|---|---|---|---|---|---|
| | | | ($ Millions) | | | |
| Current Operating Earnings | | | | | | |
| Interest & Discount on Loans | 60 | 125 | 236 | 526 | 541 | 9.0 |
| Interest, Dividends & Trading Profits on Securities | 71 | 101 | 128 | 182 | 197 | 2.8 |
| Exchange, Commission, Service Charges and other current Operating Earnings | 41 | 56 | 89 | 135 | 143 | 3.5 |
| Total Current Operating Earnings | 172 | 282 | 454 | 842 | 880 | 5.1 |
| Current Operating Expenses | | | | | | |
| Interest on Deposits | 35 | 58 | 105 | 271 | 291 | 8.3 |
| Remuneration to Employees | 56 | 102 | 153 | 230 | 244 | 4.4 |
| Contributions to Pension Funds | 4 | 12 | 14 | 13 | 13 | 3.0 |
| Provision for Depreciation of Premises | 3 | 7 | 10 | 18 | 20 | 7.0 |
| Other Current Operating Expenses | 27 | 45 | 70 | 114 | 123 | 4.6 |
| Total Current Operating Expenses | 124 | 220 | 352 | 646 | 690 | 5.6 |
| Net Current Operating Earnings | 48 | 62 | 102 | 197 | 190 | 4.0 |
| Provision for Income Taxes | 13 | 16 | 37 | 91 | 102 | 7.8 |
| Dividends Paid | 10 | 16 | 26 | 54 | 58 | 6.0 |
| Net Available for Losses or for General Contingencies | 25 | 30 | 38 | 52 | 30 | 1.0 |
| Net Capital Profits (Loss) | — | — | (1) | 4 | 2 | 2.0 |

SOURCE: *Canada Gazette*. Compiled from returns made pursuant to Section 106 of the Bank Act.

## TABLE II

## CANADIAN CHARTERED BANKS
## EARNINGS AND EXPENSES

| | 1945 | 1950 | 1955 | 1960 | 1961 |
|---|---|---|---|---|---|
| | (Percentage of Total Operating Earnings) | | | | |
| Current Operating Earnings | | | | | |
| Interest & Discount on Loans | 35 | 44 | 52 | 62 | 61 |
| Interest, Dividends, & Trading Profits on Securities | 41 | 36 | 28 | 22 | 22 |
| Exchange, Commission, Service Charges & Other Current Operating Earnings | 24 | 20 | 20 | 16 | 16 |
| Total Current Operating Earnings | 100 | 100 | 100 | 100 | 100 |
| Current Operating Expenses | | | | | |
| Interest on Deposits | 20 | 21 | 23 | 32 | 33 |
| Remuneration to Employees | 33 | 36 | 34 | 27 | 28 |
| Contributions to Pension Funds | 2 | 4 | 3 | 2 | 1 |
| Provision for Depreciation of Premises | 2 | 2 | 2 | 2 | 2 |
| Other Current Operating Expenses | 16 | 16 | 15 | 14 | 14 |
| Total Current Operating Expenses | 73 | 78 | 78 | 77 | 78 |
| Net Current Operating Earnings | 27 | 22 | 22 | 23 | 22 |
| Provision for Income Taxes | 7 | 6 | 8 | 11 | 12 |
| Dividends Paid | 6 | 6 | 6 | 6 | 7 |
| Net Available for Losses & for General Contingencies | 15 | 10 | 9 | 6 | 3 |

**306.** As shown in Table III, the average rate of return on loans has also increased over the post-war period from 4.13 per cent in 1945 to a high of 5.88 per cent in 1960; it was 5.86 per cent in 1961. Part of the increase in loan revenue is therefore the result of changes in interest rates. The prime lending rate remained at $4\frac{1}{2}$ per cent during the post-war period to April 23, 1956, when it was raised to five per cent. Since then it has varied between five per cent and $5\frac{3}{4}$ per cent. The last change occurred on June 1st, 1961, when it was reduced to $5\frac{1}{2}$ per cent, where it remains at the time of writing.

**307.** While the rate of return on total loans has tended to follow changes in the prime lending rate, the total revenue from loans does not move directly with interest rates since increases in the prime rate are usually accompanied by, and are indicative of, restrictive lending policies in response to central bank action. Consequently, the growth of bank loans, discussed elsewhere in this submission, naturally has an important bearing on the growth of revenue from this source.

**308.** Interest, dividends and trading profits on securities were $2\frac{1}{2}$ times larger in 1961 than in 1945 compared with the nine-fold increase in interest on loans. Income from securities has, as a result, decreased sharply as a per cent of total revenue. This trend is, of course, related to the declining trend of security holdings already mentioned.

**309.** The average rate of return on securities has been increasing over the post-war period in keeping with the rising trend in interest rates generally. In 1945 the banks

earned an average of 1.87 per cent on their securities, including trading profits, compared with 3.94 per cent in 1960 and 3.81 per cent in 1961.

310. Earnings from securities are held down to some extent by the nature of the bank's operations. When loan demand is strong the banks have traditionally shifted from securities to loans to meet this demand and their customers have come to expect such continued support. But when loan demand is high, interest rates are also high and bond prices are low. Thus, as fully discussed elsewhere in this brief, the banks often find themselves selling securities at the bottom of the market and buying at the top, when loan demand is slack and interest rates are relatively low.

## TABLE III

### EARNINGS RATIOS
### CANADIAN CHARTERED BANKS AND U.S. COMMERCIAL BANKS

| | | 1945 | 1950 | 1955 | 1960 | 1961 |
|---|---|---|---|---|---|---|
| | | % | % | % | % | % |
| **Percentage of Total Assets*** | | | | | | |
| Total current earnings | —Canada | 2.59 | 3.16 | 3.83 | 5.17 | 5.04 |
| | U.S. | 1.80 | 2.51 | 3.07 | 4.39 | 4.51 |
| Net current earnings | —Canada | 0.70 | 0.66 | 0.86 | 1.21 | 1.09 |
| | U.S. | 0.75 | 0.97 | 1.11 | 1.58 | 1.58 |
| Net earnings available for dividends and losses | —Canada | 0.53 | 0.50 | 0.54 | 0.65 | 0.50 |
| | U.S. | 0.55 | 0.70 | 0.72 | 1.02 | 1.19 |
| **Percentage of Total Capital Accounts*** | | | | | | |
| Net current earnings | —Canada | 15.31 | 16.69 | 18.64 | 20.53 | 18.54 |
| | U.S. | 13.11 | 13.97 | 15.40 | 19.53 | 18.86 |
| Net earnings available for dividends and losses | —Canada | 11.48 | 12.71 | 11.93 | 11.08 | 8.59 |
| | U.S. | 9.53 | 10.08 | 9.97 | 12.60 | 14.19 |
| Dividends declared | —Canada | 3.15 | 4.41 | 4.81 | 5.64 | 5.64 |
| | U.S. | 3.29 | 3.55 | 3.87 | 4.17 | 4.20 |
| **Rates of Return on Securities including Trading Profits** | —Canada | 1.87 | 2.31 | 2.69 | 3.94 | 3.81 |
| | U.S. | 1.61 | 1.73 | 1.90 | 3.18 | 3.49 |
| **Rates of Return on Loans** | —Canada | 4.13 | 4.49 | 4.78 | 5.88 | 5.86 |
| | U.S. | 3.01 | 4.27 | 4.78 | 5.86 | 5.94 |

* Figures for Assets and Capital Accounts are:

(a) in Canada—average of month ends for fiscal year.

(b) U.S. average of figures reported on call dates at the beginning, middle and end of each year (4 call dates for 1961).

SOURCES: Canada—*Canada Gazette.*

U.S.A.—*Federal Reserve Bulletin,* May 1961.
Annual Report of the F.D.I.C., 1961.
Banks included are those which are members of the Federal Deposit Insurance Corporation.

311. The chartered banks' revenue from charges to customers for banking services consists principally of four types of charges:

(a) Service charges on deposit accounts
(b) Charges connected with foreign exchange transactions and foreign collections
(c) Domestic exchange and commissions on cheques and drafts
(d) Charges for safety deposit boxes and safekeeping of securities and other valuables.

312. While revenues from these sources increased some $3\frac{1}{2}$ times between 1945 and 1961, they have declined from almost 24 per cent of total revenues in 1945 to 16 per cent in 1961.

313. Service charges on deposit accounts now represent some 28 per cent of total miscellaneous earnings in contrast with 14 per cent in 1950. This reflects increases in both rates charged and in deposit velocity. A comprehensive cost analysis was conducted in 1961 in order to determine the reasonableness of present service charges. It was found that in general costs are now above the present customary scale of bank service charges.

314. It is apparent that service charge rates have not been sensitive to rising costs, and the minimum rates have been revised upward at intervals only when it became obvious that they were much out of line with costs. Competition for deposit customers between the banks themselves and with the non-bank financial institutions results in the minimums seldom being exceeded.

315. Rates on other standard bank services have been even less frequently increased. There have been no changes in exchange rates on out-of-town cheques since the Bank Act revision of 1900 and apart from increases in the charges applicable to small items the same has held true for basic collection charges. Safety deposit box charges have remained unchanged since 1949, money order commissions since 1948. Commissions on foreign exchange services have increased in the past decade but only slightly. Consequently, while revenue from these sources has varied in volume, it has not kept pace with rising costs and this, coupled with sharp increases in earning assets, has resulted in its decline as a proportion of total revenue.

316. In general it would seem preferable for service charges to match the cost of services rendered as far as practical. If, for instance, service charges are waived in view of the large borrowings of a customer this really results in an effective charge for interest below the going rate. Free services in line with free balances kept seems equitable if this results in the banks paying for funds by way of service provided. But if each service does not bear its own cost then, the effect is that one class of customer must subsidize another.

**Trends in U.S. Commercial Bank Earnings**

317. Tables IV and V show earnings statistics for U.S. commercial banks. It will be seen that their earnings pattern is very similar to that in Canada. There has been the same shift in the major source of earnings from securities to loans in the post-war period, and the relative proportion of revenue derived from loans and from securities is similar in both countries.

318. It is interesting to note that the rate of return on loans in the two countries has been roughly the same as shown in Table III; in this connection it must not be overlooked that it is a common practice in the U.S.A. to require compensating deposit balances against loans, which raises the effective cost of borrowing to a level substantially above that indicated by the nominal interest rate. The rate of return in securities earned by the Canadian banks has been consistently higher than that earned by U.S. commercial banks because bond yields in Canada have usually been higher than those in the United States. While in 1945 Canadian Banks were able to earn a greater relative share of total earnings from service charges, the Canadian share has fallen some eight

percentage points in the intervening years in comparison with a decline of only three points in the U.S.A.

## TABLE IV

## U.S. COMMERCIAL BANKS EARNINGS AND EXPENSES

| | 1945 | 1950 | 1955 | 1960 | 1961 | 1961÷1945 —times— |
|---|---|---|---|---|---|---|
| | ($ Millions) | | | | | |
| Current Operating Earnings | | | | | | |
| Interest & Discount on Loans | 708 | 1,976 | 3,626 | 6,699 | 6,891 | 9.7 |
| Interest, Dividends & Trading Profits on Securities | 1,434 | 1,293 | 1,520 | 2,478 | 2,919 | 2.0 |
| Exchange, Commission, Service Charges and other Current Operating Earnings | 474 | 714 | 1,067 | 1,656 | 1,646 | 3.5 |
| Total Current Operating Earnings | 2,616 | 3,983 | 6,213 | 10,833 | 11,456 | 4.4 |
| Current Operating Expenses | | | | | | |
| Interest on Deposits | 233 | 343 | 678 | 1,872 | 2,145 | 9.2 |
| Remuneration to Employees | 691 | 1,202 | 1,896 | 2,798 | 2,899 | 4.2 |
| Provision for Depreciation | 40 | 59 | 108 | 212 | 510 | 12.8 |
| Other Current Operating Expenses | 559 | 841 | 1,278 | 2,051 | 1,886 | 3.1 |
| Total Current Operating Expenses | 1,523 | 2,445 | 3,960 | 6,933 | 7,440 | 4.9 |
| Net Current Operating Earnings | 1,093 | 1,538 | 2,253 | 3,900 | 4,016 | 3.7 |
| Provisions for Income Taxes | 299 | 428 | 794 | 1,384 | 1,406 | 4.7 |
| Dividends | 274 | 391 | 566 | 832 | 895 | 3.3 |
| Net Available for Losses or for General Contingencies | 520 | 719 | 893 | 1,684 | 1,715 | 3.3 |

SOURCE: *Federal Reserve Bulletin.*

### Expenses of the Chartered Banks

319. The current operating expenses of the chartered banks rose 5½ times in the post-war period from $124 million in 1945 to just over $690 million in 1961. As will be seen from Table I, while all major items of expenses have increased, there has been a considerable change in the relative importance of different items.

320. In 1945 interest on deposits amounted to $34.8 million, representing 20 per cent of total operating earnings; by 1961 interest amounted to $290.8 million, or 33 per cent of the total. Interest paid on deposits is now the largest single item of bank expenses.

321. This growth is attributable to substantial increases in both the rates of interest paid on deposits and the total amount of interest-bearing deposits. Because Canadian statistics do not segregate interest-bearing deposits—part of government, foreign and other bank deposits, for example, are interest-bearing—it is not possible to calculate an actual rate paid. However, the standard rate on personal savings deposits which was 1½ per cent in 1945 has risen to 2¾ per cent. The rates on other notice deposits have

increased even more. In 1945 the rate paid for other notice deposits was $\frac{1}{2}$ per cent; today it runs to $3\frac{3}{4}$ per cent for fixed-term deposits, and ordinary corporate notice deposits obtain $2\frac{3}{4}$ per cent.

### TABLE V

### U.S. COMMERCIAL BANKS
### EARNINGS AND EXPENSES

| | 1945 | 1950 | 1955 | 1960 | 1961 |
|---|---|---|---|---|---|
| | (Percentage of Total Current Earnings) | | | | |
| Current Operating Earnings | | | | | |
| Interest and Discount on Loans | 27 | 50 | 58 | 62 | 60 |
| Interest, Dividends and Trading Profits on Securities | 55 | 32 | 24 | 23 | 26 |
| Exchange, Commission, Service Charges and other Current Operating Earnings | 18 | 18 | 17 | 15 | 14 |
| Total Current Operating Earnings | 100 | 100 | 100 | 100 | 100 |
| Current Operating Expenses | | | | | |
| Interest on Deposits | 9 | 9 | 11 | 17 | 19 |
| Remuneration to Employees | 26 | 30 | 30 | 26 | 25 |
| Provision for Depreciation | 2 | 1 | 2 | 2 | 4 |
| Other Current Operating Expenses | 21 | 21 | 21 | 19 | 16 |
| Total Current Operating Expenses | 58 | 61 | 64 | 64 | 65 |
| Net Current Operating Earnings | 42 | 39 | 36 | 36 | 35 |
| Provision for Income Taxes | 11 | 11 | 13 | 13 | 12 |
| Dividends | 10 | 10 | 9 | 8 | 8 |
| Net Available for Losses or for General Contingencies | 20 | 18 | 14 | 16 | 15 |

322. It is apparent that the rate of interest which the banks pay on deposits cannot for long increase faster than the rate of interest earned by the banks on their loans. In 1945 there was a spread of three per cent between the standard rate of interest paid on personal savings deposits of $1\frac{1}{2}$ per cent and the prime lending rate of $4\frac{1}{2}$ per cent; since then this spread has been reduced to $2\frac{3}{4}$ per cent. At the same time with the rate of interest paid on the growing volume of other notice deposits increasing from $\frac{1}{2}$ per cent to as much of $3\frac{3}{4}$ per cent for deposit receipts, and even higher in the case of term notes with maturities over one year, the spread has been reduced even more.

323. The large post-war increase in Canadian notice deposits has been discussed elsewhere in this submission. However, in addition to increased interest expense for Canadian deposits there has been a rapid growth in recent years in interest-bearing deposits in foreign currencies. The rate of interest paid on these deposits is sometimes higher than the amount paid on Canadian deposits, in line with the rate of interest at which the funds can be employed in international markets.

324. The second largest item of bank expense is salaries and wages. In total these items were $4\frac{1}{2}$ times larger in 1961 than in 1945, rising to \$244 million from \$56 million. In 1961 salaries represented 61 per cent of total operating expenses, exclusive of interest paid.

325. The contributions by the banks to their employees' pension funds have risen from year to year as the number of employees and the amount of salaries have increased. The banks have also made lump-sum payments to these funds as the actuarial needs of the funds have required. In total, contributions by the banks to their pension funds rose from $3.8 million in 1945 to $13.3 million in 1961.

326. The proportion of the banks' operating expenses set aside for depreciation has remained fairly constant during the post-war period. The total amount involved, however, has increased substantially from $3.2 million in 1945 to $19.6 million in 1961. This increase has resulted in the main from the renovation and expansion of older branches and to a lesser extent from the construction of new ones.

327. Of the other current operating expenses, comprising 14 per cent of total earnings in 1961, the more important items are for outlays for advertising and publications, communication, property, stationery, miscellaneous taxes and travelling. Of these, property costs are by far the largest, accounting for 40 per cent of such sundry expenses.

### Trends in U.S. Commercial Bank Expenses

328. U.S. experience on costs has been broadly similar to Canada's. Interest expense has increased noticeably in relation to earnings in both countries. However, the proportion of total expense paid as interest is much lower in the United States than in Canada. This is because, as noted earlier in this brief, the proportion of interest-bearing notice deposits to total deposits is much lower in U.S. commercial banks than in the Canadian chartered banks. Other current operating expenses are proportionately greater in the U.S. than in Canada, possibly because of the economies of Canada's branch system.

### Net Current Operating Earnings

329. In addition to the factors discussed above which have affected the growth of earnings and expenses, two other trends have affected net earnings. First, the shift from lower-yielding securities to higher-yielding loans has produced an increase in the return on total bank assets. As will be seen from Table III, the ratio of earnings to total assets has increased from 2.60 per cent in 1945 to 5.17 per cent in 1960 and was 5.04 per cent in 1961.

330. At the same time, however, the distribution of the banks' liabilities has changed. There has been a relative shift from non-interest-bearing deposits to interest-bearing deposits. Canadian notice deposits increased from some 47 per cent of total Canadian deposits in 1945 to 64 per cent in 1961. In addition, as mentioned earlier, there has been a substantial increase in foreign interest-bearing deposits. Thus, the banks have been faced with a trend towards relatively higher costs for their deposits which has offset part of the gains from the higher return on assets.

331. Nevertheless, net operating profits before provision for losses and income taxes have increased from $46.7 million in 1945 to $189.9 million in 1961, a four-fold gain, and expressed as a percentage of total assets have increased from 0.707 per cent at the end of the war to 1.087 per cent in 1961. This net rate of return on assets, however, is below that earned by United States commercial banks which amounted to 1.11 per cent in 1955 and 1.58 per cent in 1960.

332. Furthermore, it appears unlikely that the chartered banks will be able to increase the net return on total assets much above present levels. The post-war shift from low-yielding securities to loans seems to be approaching an end with the ratio of risk assets to deposits near 70 per cent. At the same time the shift from non-interest-bearing to interest-bearing deposits has shown no sign of slowing down.

333. It is apparent from Tables II and V that net operating earnings represent a

much higher percentage of total earnings in the United States than in Canada, with the interest paid on deposits the chief reason for the difference. Income taxes were 13 per cent of total 1960 earnings in the U.S. and 11 per cent in Canada while dividends were eight per cent in the U.S.A. and six per cent in Canada. The most marked difference in the two countries was that the proportion of retained earnings including all provisions for losses or contingencies were 16 per cent of total operating earnings in the United States as compared to six per cent in Canada.

**334.** In the United States, the ratio of capital to total assets is higher than in Canada. In spite of this, Table III shows that net current earnings as a percentage of capital funds have been only slightly lower in the U.S.

**335.** The above paragraphs have described total earnings and expenses of the banks regardless of where they were earned or incurred. It has only been in the last two years, however, that figures on the allocation of earnings as between domestic and foreign business have been reported to the Inspector General of Banks along with the required Schedule Q return. While these new figures may not completely allocate earnings and expenses between domestic and foreign business—depreciation, for example, is charged in toto against domestic earnings—some indication of the importance of foreign business may be gained from the fact that these figures show that foreign net earnings have amounted to 12 per cent of total net earnings in both 1960 and 1961.

**Bank Capital**

**336.** Capital funds of Canadian banks consist of paid-up capital, rest account and undivided profits. The three categories together make up the total of "shareholders' equity."

**337.** It is generally accepted that one of the primary uses of capital for banks, as for other types of business enterprises, is the provision of the physical means of doing business, including, among other things, buildings, equipment, furniture and the "tools of the trade." For this reason, "bank premises" accounts have been deducted from "shareholders' equity" in certain ratios and tables as well as in the discussion of trends and adequacy of capital.

**338.** Another major purpose of capital is to ensure the protection of depositors' funds and the continuance of the bank as a going concern. From the viewpoint of depositors this assurance means that confidence in the bank is maintained at all times, since it is considered there is enough capital in the banking institution to absorb losses that may reasonably be expected to occur in the future. The amount of capital required for this purpose will, of course, be influenced by the amount of the banks' contingency reserves. In Canada, the nature of chartered banks assets has changed over the years. The banks now hold a large proportion of government bonds and loans guaranteed in some degree by the Federal Government. Consequently, the decline of the capital-to-deposit ratio in Canada and in other major countries has not been cause for alarm.

**339.** A further point is that most Canadian chartered banks are international in scope, with operations in a number of countries. Many of these countries require banks to maintain capital within the countries concerned. In other countries capital is necessary for the same reasons as prevail in Canada even if no statutory obligations are laid down.

**340.** The trend of capital in relation to deposits and risk assets is shown in Tables VI and VII. While shareholders' equity has increased about four-fold since 1925, deposits have increased more than six times during the same period. The ratio of capital to deposits was 10.7 per cent in 1925, it increased slightly during the early thirties, then began a slow decline to a low point of 4.0 per cent in 1952. In subsequent years, new issues of capital raised the ratio; at the end of 1961 it stood at 6.1 per cent. The ratio of capital excluding bank premises to deposits showed a similar pattern.

## TABLE VI

## CANADIAN CHARTERED BANKS
## RATIO OF SHAREHOLDERS' EQUITY TO DEPOSITS

| Dec. 31st | Deposits** | Shareholders' Equity* | | Shareholders' Equity* Less Bank Premises | |
|---|---|---|---|---|---|
| | ($ Millions) | ($ Millions) | % | ($ Millions) | % |
| 1925 | 2,366 | 254 | 10.7 | 173 | 7.3 |
| 1926 | 2,410 | 257 | 10.6 | 179 | 7.4 |
| 1927 | 2,653 | 271 | 10.2 | 195 | 7.4 |
| 1928 | 2,816 | 275 | 9.8 | 198 | 7.0 |
| 1929 | 2,820 | 318 | 11.3 | 238 | 8.4 |
| 1930 | 2,565 | 322 | 12.6 | 237 | 9.2 |
| 1931 | 2,426 | 322 | 13.3 | 235 | 9.7 |
| 1932 | 2,306 | 316 | 13.7 | 229 | 9.9 |
| 1933 | 2,294 | 286 | 12.5 | 201 | 8.8 |
| 1934 | 2,405 | 287 | 11.9 | 201 | 8.4 |
| 1935 | 2,609 | 287 | 11.0 | 202 | 7.7 |
| 1936 | 2,773 | 289 | 10.4 | 205 | 7.4 |
| 1937 | 2,819 | 291 | 10.3 | 210 | 7.4 |
| 1938 | 2,986 | 292 | 9.8 | 211 | 7.1 |
| 1939 | 3,378 | 294 | 8.7 | 214 | 6.3 |
| 1940 | 3,277 | 295 | 9.0 | 217 | 6.6 |
| 1941 | 3,634 | 296 | 8.1 | 221 | 6.1 |
| 1942 | 4,287 | 297 | 6.9 | 224 | 5.2 |
| 1943 | 5,149 | 297 | 5.8 | 227 | 4.4 |
| 1944 | 5,997 | 301 | 5.0 | 236 | 3.9 |
| 1945 | 6,884 | 299 | 4.3 | 234 | 3.4 |
| 1946 | 7,226 | 333 | 4.6 | 268 | 3.7 |
| 1947 | 7,406 | 340 | 4.6 | 269 | 3.6 |
| 1948 | 8,002 | 346 | 4.3 | 268 | 3.3 |
| 1949 | 8,177 | 353 | 4.3 | 266 | 3.3 |
| 1950 | 8,867 | 361 | 4.1 | 255 | 2.9 |
| 1951 | 9,003 | 375 | 4.2 | 255 | 2.8 |
| 1952 | 9,570 | 381 | 4.0 | 256 | 2.7 |
| 1953 | 10,140 | 419 | 4.1 | 309 | 3.0 |
| 1954 | 10,713 | 521 | 4.9 | 406 | 3.8 |
| 1955 | 11,904 | 567 | 4.8 | 441 | 3.7 |
| 1956 | 12,531 | 653 | 5.2 | 509 | 4.1 |
| 1957 | 13,234 | 732 | 5.5 | 573 | 4.3 |
| 1958 | 14,767 | 813 | 5.5 | 636 | 4.3 |
| 1959 | 14,651 | 926 | 6.3 | 720 | 4.9 |
| 1960 | 15,575 | 1,004 | 6.4 | 770 | 4.9 |
| 1961 | 17,674 | 1,071 | 6.1 | 817 | 4.6 |

* Capital, Rest Fund and Undivided Profits.

** Deposits in Canada and elsewhere in Canadian and other currencies.

SOURCE: *Canada Gazette*.

# TABLE VII
## CANADIAN CHARTERED BANKS

| | | Shareholders' Equity Less Bank Premises as a Percentage of: | | | |
|---|---|---|---|---|---|
| | | 1 | 2 | 3 | 4 |
| Dec. 31st | Shareholders' Equity less Bank Premises | Total Loans and Securities Other than Canadian Federal, Provincial and Municipal Securities | 1 Plus Canadian Municipal Securities | 2 Plus Provincial Government Securities | 3 Plus Canadian Federal Securities with Maturity over two Years |
| | ($ Millions) | % | % | % | % |
| 1925 | 173 | 10.3 | 9.9 | | |
| 1926 | 179 | 9.8 | 9.5 | | |
| 1927 | 195 | 9.6 | 9.4 | | |
| 1928 | 198 | 9.0 | 8.8 | Percentages | |
| 1929 | 238 | 10.0 | 9.9 | 3 and 4 commence | |
| 1930 | 237 | 12.4 | 12.0 | with first year | |
| 1931 | 235 | 13.6 | 13.0 | in which Government | |
| 1932 | 229 | 15.2 | 14.3 | Return showed the | |
| 1933 | 201 | 14.0 | N.A. | appropriate totals. | |
| 1934 | 201 | 14.9 | 14.0 | | |
| 1935 | 202 | 15.5 | 14.5 | | |
| 1936 | 205 | 16.3 | 15.0 | | |
| 1937 | 210 | 16.2 | 15.0 | | |
| 1938 | 211 | 15.8 | 14.7 | 11.5 | |
| 1939 | 214 | 14.6 | 13.8 | 11.0 | |
| 1940 | 217 | 15.2 | 14.4 | 11.6 | |
| 1941 | 221 | 15.0 | 14.3 | 11.7 | |
| 1942 | 224 | 15.3 | 14.7 | 12.0 | |
| 1943 | 227 | 15.4 | 14.9 | 12.4 | |
| 1944 | 236 | 14.6 | 13.9 | 11.9 | 7.6 |
| 1945 | 235 | 12.3 | 11.7 | 10.1 | 5.4 |
| 1946 | 268 | 12.8 | 12.2 | 10.7 | 5.8 |
| 1947 | 269 | 9.7 | 9.4 | 8.1 | 5.0 |
| 1948 | 268 | 8.9 | 8.6 | 7.5 | 4.7 |
| 1949 | 266 | 8.6 | 8.3 | 7.3 | 4.6 |
| 1950 | 255 | 6.9 | 6.6 | 6.1 | 4.2 |
| 1951 | 255 | 6.4 | 6.2 | 5.8 | 4.0 |
| 1952 | 256 | 5.6 | 5.5 | 5.1 | 3.8 |
| 1953 | 309 | 5.8 | 5.7 | 5.5 | 4.1 |
| 1954 | 406 | 7.5 | 7.3 | 7.0 | 5.0 |
| 1955 | 441 | 6.7 | 6.5 | 6.2 | 4.8 |
| 1956 | 509 | 6.7 | 6.5 | 6.3 | 5.5 |
| 1957 | 573 | 7.0 | 6.8 | 6.6 | 5.7 |
| 1958 | 636 | 7.4 | 7.2 | 6.9 | 5.8 |
| 1959 | 720 | 7.4 | 7.2 | 7.0 | 6.3 |
| 1960 | 770 | 7.5 | 7.3 | 7.1 | 6.2 |
| 1961 | 817 | 7.3 | 7.1 | 6.9 | 6.1 |

SOURCE: *Canada Gazette.*

341. The decline in the ratio of bank capital to deposits from the 1920s to the early 1950s, and subsequent increase, have also occurred in other countries. Furthermore, in the United States the ratio for commercial banks declined from 8.2 per cent in 1930 to 7.9 per cent in 1950 and has since risen to approximately 9.7 per cent in 1961. In the United Kingdom the ratio for leading banks has moved from 7.6 per cent in 1930 to 2.6 per cent in 1950 and approximately 4.0 per cent in 1961. In all three countries the greater part of the decline reflects, in the main, the results of monetary expansion.

342. The decline in the relative size of capital funds has given rise to discussions concerning the adequacy of bank capital. Views of what is "adequate" capital have varied from time to time and from country to country as circumstances have changed.

343. Nevertheless, the size of a bank's capital remains for many depositors a measure of the bank's strength. This is undoubtedly true in an even greater degree in the field of international banking where the large and increasing share of business which Canadian banks enjoy is in no small part attributable to their capital strength as revealed in published statements.

344. Early bank charters sometimes required a specified ratio of capital to "notes issued" or "total indebtedness." To some extent these provisions regarding capital were really connected with bank liquidity as well as solvency. As pointed out elsewhere liquidity of the banking system in an era of managed money is an entirely separate problem and a much lower capital seems reasonable under current conditions.

345. Supervisory authorities in the United States came to apply a standard ratio of capital to deposits of 10 per cent, but "there appears to be no scientific basis for this particular ratio. It is simply a good round decimal, easy to calculate at a glance."[1] More recently it has come to be recognized that any simple capital-deposit ratio can be misleading: "the fundamental question on the adequacy of bank equities must be answered in relation to whether a decline which might take place in the value of the assets of a bank would cause the solvency of the bank to be in jeopardy."[2] As shown in Table VIII the ratio of capital to deposits for the 20 largest banks in the world as at the latest balance sheet date varies widely but the range for Canadian chartered banks is not out of line.

### Par Value of Shares

346. The banks at present have some 85,000 shareholders. This is an increase of 50,000 since 1944 when, in accordance with the Bank Act revision of that year, stocks were split ten for one. It seems to us desirable that widespread ownership of shares in the banks should be encouraged, but the market prices of the various bank stocks have now reached levels that tend to limit wider distribution.

347. Both in the interests of the public and in the interests of the banks themselves, some changes in the statutory $10 par value for bank shares should be considered.

### Inner Reserves

348. The chartered banks are permitted to make limited appropriations from current earnings before taxes for the purpose of providing reserves against losses on certain of their loans and securities, and their net long foreign exchange positions. The Bank Act requires that the loans of a bank be stated "less provision for estimated loss" and that all securities other than Canadian Federal and Provincial be stated at "not exceeding market value." To fulfill these requirements the banks deduct the above-mentioned reserves, known as inner reserves, from the total value of loans and eligible investments and show only a net or realizable value for these assets.

[1] Roland J. Robinson "The Capital Deposit Ratio in Banking Supervision," *Journal of Political Economy*, XLIX, February, 1941, p. 41.

[2] Louis Frohmann, "The Adequacy of Bank Capital," *Journal of Finance*, October, 1947, p. 24.

TABLE VIII

SELECTED BANKS
RATIO OF SHAREHOLDERS' EQUITY TO DEPOSITS
AND PAR VALUE OF SHARES

| | World's Largest Banks | Latest Fiscal Year End Deposits (millions*) | Shareholders' Equity (millions*) | Ratio % | Par Value of Common Shares* |
|---|---|---|---|---|---|
| 1 | Bank of America, National Trust & Savings Assn., San Francisco | 11,475 | 785 | 6.84 | 6.25 |
| 2 | Chase Manhattan Bank, N.Y. | 8,876 | 718 | 8.09 | 12.50 |
| 3 | First National City Bank, N.Y. | 8,372 | 784 | 9.36 | 20.00 |
| 4 | Manufacturers Hanover Trust Co., N.Y. | 5,521 | 454 | 8.22 | 15.00 |
| 5 | Barclays Bank Limited, London | £ 1,806 | £ 84 | 4.65 | £ 1 |
| 6 | Midland Bank Limited, London | £ 1,669 | £ 70 | 4.19 | £ 1 |
| 7 | Chemical Bank New York Trust Co. | 4,353 | 430 | 9.88 | 12.00 |
| 8 | The Royal Bank of Canada ($ Can.) | 4,502 | 306 | 6.80 | 10.00 |
| 9 | Morgan Guaranty Trust Company | 4,136 | 571 | 13.81 | 25.00 |
| 10 | Canadian Imperial Bank of Commerce ($ Can.) | 4,220 | 256 | 6.07 | 10.00 |
| 11 | Lloyds Bank Limited | £ 1,402 | £ 70 | 4.99 | £ 1 |
| 12 | Security First National Bank, L.A. | 3,662 | 271 | 7.40 | 12.50 |
| 13 | Bank of Montreal ($ Can.) | 3,647 | 208 | 5.70 | 10.00 |
| 14 | Bankers Trust Company, N.Y. | 3,391 | 310 | 9.14 | 10.00 |
| 15 | Continental Illinois National Bank and Trust Company Chicago | 3,313 | 331 | 9.99 | 33.33 |
| 16 | First National Bank, Chicago | 3,142 | 322 | 10.25 | 20.00 |
| 17 | Westminster Bank Limited, London | £ 1,022 | £ 42 | 4.09 | £ 1 |
| 18 | Deutsche Bank | DM.11,122 | DM.640 | 5.75 | DM.100 |
| 19 | Wells Fargo Bank, Am. Trust Co., S.F. | 2,712 | 201 | 7.41 | 10.00 |
| 20 | National Provincial Bank Ltd., London | £ 947 | £ 43 | 4.54 | £ 1 |
| | **Other Canadian Banks** | | | | |
| | The Bank of Nova Scotia ($ Can.) | 2,120 | 118 | 5.57 | 10.00 |
| | The Toronto-Dominion Bank " | 1,969 | 113 | 5.74 | 10.00 |
| | Banque Canadienne Nationale " | 773 | 45 | 5.82 | 10.00 |
| | La Banque Provinciale du Canada " | 399 | 19 | 4.76 | 10.00 |
| | The Mercantile Bank of Canada " | 102 | 5 | 4.90 | 10.00 |

* U.S. Dollars unless otherwise indicated.

SOURCES: Annual Reports.

349. Prior to 1944 there were no specific statutory requirements with respect to inner reserves but, as was brought out in the Proceedings at The Standing Committee of the House of Commons on Banking and Commerce in that year, the shareholders' auditors and the Minister of Finance through the Inspector General of Banks had been responsible for seeing that a bank's assets were neither over-valued nor under-valued. However, in 1944 the Bank Act was amended to charge the Minister of Finance with specific responsibility for determining the amount which, in his opinion, was a reasonable appropriation for a bank to make each year to its inner reserves. Since that time the Minister has issued periodically the Rules by which he makes this determination.

350. Inner reserves, as defined by the above-mentioned Rules, are divided into three categories: tax paid, specific and contingency. Tax paid reserves are those on which all taxes exigible by the Government have been assessed. Specific reserves are provisions allowed for potential losses that are readily discernible at the time; contingency reserves refer to additional provisions for estimated losses which, while not apparent at the time, are, nevertheless, known from experience to exist in any large body of loans and securities.

351. From 1944 to 1954 the Rules issued by the Minister first defined the assets in respect of which contingency reserves were permitted and then specified a percentage to be applied to each class of assets to arrive at the allowable reserve. The reserves so calculated were originally in addition to the specific reserves that a bank was permitted to take in order to reduce the book value of the relative assets to estimated realizable value. In 1955 the Rules were changed so that only the greater of the specific or contingency reserves on each class of assets was allowed. Again in 1957 permitted reserves were further modified to disallow reserves of any kind on certain classes of assets including Canadian Federal and Canadian Provincial securities, and finally in 1960 the fixed percentage levels for the different classes of assets were replaced by a single, variable percentage that is based on a moving average of a number of years' loss experience for the banking system as a whole.

352. The fact that such provisions are permitted as a deduction from earnings before taxes has given rise to criticism in some quarters. Even though taxes on inner reserves are deferred, it has been contended that the reserves are by now almost permanent, and the resulting permanent tax deferment is equivalent to preferential tax treatment. This is true, of course, of any provision for bad and doubtful debts. Nevertheless, the fact remains that the banks must pay taxes at the current rate on any transfers from contingency and specific reserves unless they are used for the purpose of writing off bad debts.

353. The entire concept of inner reserves was reviewed in considerable detail during the proceedings leading up to both the 1944 and 1954 revisions of the Bank Act. In 1944 the importance of inner reserves as a factor in maintaining the confidence of depositors, while at the same time giving management the freedom of carrying on the lending function effectively was explained by the Minister of Finance when he said in part:

> "It will be apparent from what I have said that the inner reserves of the banks are nothing more or less than the reserves for bad and doubtful debts which the banking business requires. They constitute the first line of defence against losses on loans and losses on investments which may have to be realized in cash on a large scale and on short notice and which by law cannot be valued at more than current market prices. If the public functions of banking are to be performed, if the banks' demand obligations to their millions of depositors are to be met, and if the banks are to provide credit freely for the needs of trade and industry, these reserves must be adequate to absorb the shocks of adverse business conditions or fluctuations in security markets. If inner reserves are inadequate, bank managements will be hesitant to grant credit freely and take the risks that proper service to the public requires. If as a result of inadequate inner reserves, banks have frequently to resort to published rest funds to meet inevitable losses on loans or shrinkage in the value of their investments, public confidence will be impaired—may be lost altogether. Once confidence is impaired, the need for inner reserves becomes all the greater. As a last resort, the central bank may come to the rescue but reliance on the central bank should not be a steady diet or be any excuse for failure of the chartered banks to maintain themselves in a sound and strong condition."

354. The lack of disclosure of inner reserves appears to cause some concern in certain directions. While it is conceded that the publication of these amounts could possibly further the interests of shareholders, it is also believed that this would be detrimental to the interests of depositors, and it has long been the practice of Canadian banking to regard their interests as paramount. In this respect the Cohen Committee on company law amendment in the United Kingdom concluded that:

> "In the case of banking companies, the interests of the depositors outweigh the interests of the shareholders and considerations affecting the public interest must be taken into account. The reputation for stability of these companies is a national asset of the first importance to the community in general, and it is not in the public interest to endanger their stability or the confidence they enjoy at home and abroad. History demonstrates the public advantage of their being able to present a reasonably stable position in a time of violent and sudden stress and for this reason, it seems to us desirable that such companies should be permitted to retain a buffer of undisclosed reserves."

355. None of the foregoing is intended to imply that the existence of undisclosed inner reserves acts to the detriment of the shareholders' interests. Notwithstanding any lack of complete disclosure there are ample safeguards for the position of a Canadian bank shareholder. The provisions of the Bank Act regarding the appointment and responsibilities of the shareholders' auditors as well as the comprehensive supervision afforded by the office of the Inspector General of Banks are as much indicative of the Government's concern with the interests of depositors and shareholders as they are evidence of its general responsibility for the continuing safety and stability of the Canadian banking system. In 1944 the Minister of Finance stressed the importance of this concept when he expressed the opinion that:

> ". . . it is a responsibility of the shareholders' auditors and of the Inspector General of Banks to see not only that inner reserves are built up to the level of adequacy but also that they do not exceed this level. Look for a moment at the position of the shareholders' auditors. If they allow over-valuation of the bank's assets, they may be jeopardizing the entire investment made by the shareholders of the bank. On the other hand, if they allow real under-valuation of the bank's assets, they are not allowing the shareholders to obtain as fair a return on their investment as the bank's earnings justify. Neither of these errors is justifiable. A proper sense of their trusteeship to the shareholders whom they represent requires the auditors to exercise the soundest judgment they possess in certifying that the assets of the bank are truly valued—that is to say, neither over-valued nor under-valued."

356. Under the present method of determination, the allowable percentage for the total of specific and contingency reserves is based on a moving average loss experience for the past 25 years for the banking system as a whole. However, by definition, reserves are a cushion against the contingencies of the future rather than those of the past and any allowance based solely on historical experience may often be inappropriate to current circumstances. It follows that if a certain percentage for inner reserves is considered adequate for a given year the actual loss experience for that year is not necessarily an accurate guide for the determination of this allowable percentage in future years. Even though losses themselves are not discernible when loans are granted, accepted accounting practice dictates that provision should be made for unidentifiable but potential losses at that time, and the banks are faced with the need for making appropriations to their inner reserves in time of prosperity with the full knowledge that these reserves will be drawn against in periods of high loss experience.

357. The application of the existing formula means that each year in the present cycle the banks are replacing low average assets and relatively high loss experience by high average assets and low loss experience. Consequently the current formula for

determining the total of specific and contingency reserves produces a somewhat anomalous result. A number of consecutively good years will push the allowable percentage down at perhaps the very time that reserves should be built up. Business has been at a relatively high level with comparatively low losses and no major down-turns for more than twenty years—certainly the longest sustained period of high activity in modern history. When the formula is calculated next year the tweny-five-year average will contain only two years of the thirties and two of the best at that, 1938 and 1939.

358. The allowable percentage for the reserve formula has been reduced substantially over the past few years. If this allowable level continues to decline in the face of sustained low loss experience, the point may be reached where the low level of reserves begins to affect the banks' day-to-day operating decisions in the extension of credit. Inadequacy of contingency reserves can hardly help but colour the viewpoint of the banks in formulating their credit policy. With reserves at a minimum following a period of prosperity they might well be compelled not only to hesitate in a subsequent recession to make the very type of loans that would be helpful in stimulating recovery but also to be less lenient in carrying a borrower through his own difficult periods.

359. It is the opinion of the banks that the continued application of the present formula may result in an allowable percentage so low as to defeat the purpose of inner reserves, and it may be that the present permitted level is already down to a point below which it would be undesirable to go. For this reason, the adoption of the principle of establishing a "floor" below which the formula would be inoperative is recommended. While the decision of where this "floor" should be established is a matter of judgment and not susceptible of accurate determination, it is the considered view of the banks that it should be established not below the permitted level for the current year so that they may be in a position to take normal credit risks in all kinds of financial weather.

# PART THREE

# FINANCIAL COMPETITION AND CONTROL

## SECTION I

## COMPETITION AMONG BANKS

### Rates and Charges

360. The chartered banks are in keen competition with other lenders and depositories in respect of most of the business they do. However, none of these other institutions offers a full range of banking services. The banks play a key role in the operation of the payments mechanism, for example, including the clearing of cheques and drafts locally, between different points in Canada, and internationally; this role attracts substantial deposit balances regardless of the interest rate structure, though it also involves costs, not at all of which are directly recoverable from the beneficiaries.

361. In general, bank interest rates on deposits and on loans must conform fairly closely to the over-all structure of comparable interest rates, but there is some scope for variation because bank loan and deposit facilities are associated with other banking services that must be paid for in one way or another.

362. Among the chartered banks themselves, however, competition must take a different form. The various banks offer a virtually identical range of services to the public, and no one bank has a monopoly of staff and facilities capable of performing these services in a courteous and efficient manner. It is obvious that any bank will have to meet the best rate offered by other banks in any major category of service, otherwise it will lose virtually all of its business in that line; there is therefore little scope for differences between banks in respect of interest rates or charges. For example, if the interest rate structure is considered unbalanced, there may be some question as to whether it is lending rates or deposit rates that should be changed. Almost invariably the bank which is willing to operate at the rate most favourable to its customers sets the pattern for all the others; no one bank or group of banks could long continue to exact terms less favourable than any one bank or a minority of banks was prepared to offer.

363. In arriving at loan and deposit interest rates, important factors are of course the statutory requirements to maintain a cash reserve of eight per cent and the voluntary agreement to maintain a liquid-asset ratio of 15 per cent; the cash component earns no interest and the secondary reserves normally yield relatively low interest. These requirements limit the amount the banks can earn from the employment of their funds, and thus limit what can be paid to depositors. Also, there must be sufficient spread between lending and deposit rates to cover banking costs.

364. Lending is done at rates above the prime rate where justified by the circumstances, but in any case the interest rate may not exceed six per cent; branch managers are continually on the lookout for good customers, and ready to seize any opportunity to gain an account from another bank. Discretion is permissible in levying certain charges in the case of a customer who carries substantial free balances or whose business otherwise warrants special consideration.

365. In the field of international banking the situation is complicated by the ease with which international corporations can transfer funds across international boundaries, and by the international operations of foreign banks; practices in this area have already been discussed in connection with the foreign currency business of the Canadian banks.

366. Under some circumstances a bank may perform special services for a customer without levying a specific charge. For example, it may sort and list cheques submitted through the clearings on behalf of a customer who maintains adequate deposit balances. Many other forms of service may be undertaken on occasion, especially to assist a new customer who is just becoming established in the area—such things as finding office space for him, obtaining information on market conditions, discussion of business conditions generally or in the customer's industry, and so on.

**Competitive Practices**

367. The chartered banks compete actively in a variety of ways. Perhaps the most important is the competition for credit business, which offers the potential borrower the opportunity of discussing his needs with various bankers—including the managers of other branches of the same bank as well as other banks. A different manager may take a different view of the circumstances, or see a new way of meeting the customer's needs.

368. In the last analysis successful banking depends on good judgment about individual borrowers and business propositions, coupled with sufficient imagination to assist customers in overcoming difficulties, and these qualities are highly personal. One manager may see no prospect of success for a particular enterprise, say a small manufacturing operation that does not seem to be proving out; another may perhaps see that the technical side of the operation is good but the marketing side or the financial management needs tightening up, and may thereby help to convert a near-bankrupt business into a prosperous customer.

369. Whenever the spread between the prime rate and the ceiling rate permits, competition occurs in respect of the interest rates offered on loans that are not entitled to the prime rate. Naturally there are differences in judgment as to who is entitled to the prime rate, or how much above the prime rate the particular borrower should be charged.

370. Another field of intense competition is in what is known as business development. The banks are continually on the lookout for opportunities to attract new enterprises, both domestic and foreign, and to assist in the expansion of established concerns. Prospects are aided in a wide variety of ways, as already mentioned.

371. A part of the competition in these fields takes the form of specialized knowledge of and service to particular industries. For example, several banks operate petroleum departments designed to serve that industry in Western Canada. Others have developed certain expertise in mining, agriculture, fishing, lumbering, or particular manufacturing industries, such as textiles and clothing. Similarly, most banks have economics departments which, in addition to their services to management, provide information to the general public through publications or which may offer advisory services to customers.

372. Competition for personal loans is also important, both among the banks themselves and between banks and other lenders, though its scope is limited at times when the authorities feel it necessary to discourage this type of lending. From the point of view of the banks however, it is valuable business in itself, and it often leads to handling other banking business for the customer who takes out a personal loan.

373. There is active competition in soliciting deposit accounts, on a basis more or less paralleling the competition for credit business. Much depends on a good personal relationship between the staff of a particular branch and its customers. Various banks compete by offering special savings deposit plans of one kind or another, such as Christmas Clubs and term savings plans.

374. As already mentioned, competition for foreign business is particularly intense. Here Canadian banks must meet the terms of the great international banks of other countries, but they also compete vigorously among themselves.

### Branches

375. The opening of bank branches in the right places and at the right time is an important aspect of inter-bank competition. A wide and efficiently distributed network of banking offices has always been essential to any banking system in rendering service to its customers, and never more so than today. Branch banking as it has developed in Canada has shown itself capable of meeting this need admirably, from earliest times to the present. During the settlement of the prairies in the first third of this century, for example, branches brought the full range of banking services to the newest community without delay and made resources available that were not limited to local liquid savings. That is equally true of today's physical frontiers. There are branch banks at Frobisher in the eastern Arctic Islands, at Port Radium and Hay River in the Northwest Territories, and at Inuvik near the mouth of the Mackenzie River. Construction crews were greeted by the staff of a branch bank when they completed pushing the railroad through 360 miles of wilderness into Schefferville, Quebec. Banking facilities were available in Kitimat, B.C., before there was a house on the townsite. A branch bank opened in Leduc, Alberta, the day after the first producing well was brought in.

376. Branch banking has also been successful in meeting the demands of the dispersal of population and industries around the peripheries of major cities and the development of new industrial areas. This phenomenon is perhaps less spectacular than the enlargement of our geographic frontiers, but it is a pervasive movement that is affecting a much larger proportion of all bank customers. These shifts have accentuated the problem of bringing banking service to the customers rather than expecting the customers to travel long distances to do their banking.

377. The obverse of this is that in a branch banking system each bank must maintain a network of branches across the country, and at well-chosen locations covering strategic sections of principal centres and metropolitan areas, in order to bring its services close to existing customers and new prospects. A branch network also provides co-ordinated Canada-wide banking service admirably suited to the needs of those business firms that must also operate across the country. Accordingly, branch development gets a great deal of thought and attention in every bank.

378. The decision to open a new branch in a given location is based on a variety of considerations. It must fit in with the needs of a balanced geographic distribution of branches across the country. The prospects for business growth in the general area to be served must be carefully examined. The particular site must be convenient to existing and prospective customers. The number and location of branches of other banks near by and of other branches of the same bank must be considered, for there is no profit in entering an area that is already over-banked no matter how promising it is in other respects.

379. A bank tries to be alert to locations that will serve the public and eventually pay for themselves. No branch is expected to be profitable from the start, though this does happen in exceptional cases. Generally speaking, however, a new branch is expected to start earning a profit within three to five years and will not be opened unless there are good reasons to believe that this will be accomplished. As recently opened branches become profit-earning, a bank is usually more ready to open new ones. If a branch shows persistent losses in spite of skilful management and vigorous efforts at business development it will be closed.

### Bank Premises

380. Since 1945 the chartered banks have made substantial expenditures on premises in order to make up for depreciation deferred during depression and war years, to accommodate the larger staffs made necessary by shorter hours and reduced overtime, to handle the rapidly-increasing volume of business being done year by year, and to keep up with modern trends in business construction, burglar proofing, and banking facilities generally.

The bulk of the increase in expenditure has been on the modernization and improvement of structures already in existence in 1946; new branches account for a much smaller portion, even though many new branches have been opened. During this period there has also been a tendency towards administrative decentralization and increased responsibilities for the branch manager. In the past a good many branches were thought of primarily as savings offices, as they did relatively little lending business and functioned essentially as collectors of deposits. Nowadays, however, the decentralization of industry has greatly broadened the scope of branch activities, and there are few branches that do not have a substantial lending business. Besides requiring a higher standard of branch management, this has required more commodious branch premises. Advantage has been taken of the opportunity thus offered to introduce modern architectural advances and up-to-date ideas on furnishings and equipment. Air-conditioning is steadily becoming more widespread.

### BANK PREMISES, ASSETS, AND SHAREHOLDERS' FUNDS, SELECTED YEARS

| End of Year | Shareholders' Equity | Total Assets | Bank Premises* | Ratio of Premises to: Equity | Assets |
|---|---|---|---|---|---|
| | (. . . Millions of dollars . . .) | | | | |
| 1926 | 256.9 | 2,939.9 | 70.4 | 27.4% | 2.4% |
| 1931 | 321.6 | 2,977.7 | 79.8 | 24.8% | 2.7% |
| 1936 | 288.5 | 3,242.3 | 74.9 | 26.0% | 2.3% |
| 1941 | 296.1 | 4,136.6 | 69.4 | 23.4% | 1.7% |
| 1946 | 332.7 | 7,798.6 | 64.2 | 19.3% | .8% |
| 1951 | 374.8 | 9,609.8 | 120.0 | 32.0% | 1.2% |
| 1956 | 652.8 | 13,427.9 | 143.5 | 22.0% | 1.1% |
| 1961 | 1,071.0 | 19,153.5 | 254.2 | 23.7% | 1.3% |

SOURCE: Statements of the Assets and Liabilities of the chartered banks of Canada compiled from returns submitted pursuant to Section 103 of the Bank Act and published at various dates as supplement to the *Canada Gazette*.

*Excludes controlled realty companies.

381. The accompanying table shows shareholders' equity, total assets, and bank premises for selected year-ends. It will be noted that in 1946 the ratio of premises to total assets had fallen to about one-third the level of the 1920's and 1930's, as assets grew during the war while premises declined somewhat; the subsequent expansion of premises raised the ratio once more, and for ten years it has remained close to 1.2 per cent. On the other hand the ratio of premises to shareholders' equity appears to have stabilized again at about the pre-war level, after a moderate drop during the war and a sharp rise in the early post-war years. The abnormally high ratio in 1951 was brought about by the sharp expansion of premises in the preceding five years, which was then offset by a parallel growth of shareholders' equity in the next five years. It would appear, however, that the relative stability of the premises-equity ratio is not due to any preconceived idea of a necessary relationship but to the fact that the needs for both premises and capital are similarly related to the general volume of business done.

**Entry Into the Banking Business**

382. Traditionally in Canada entry into the banking business has been carefully regulated under the Bank Act in the interests of ensuring a sound and reliable system. In earlier days the statutory provisions with respect to minimum capital requirements and

the scrutiny of the authorities were doubtless the major obstacles to be overcome. Nowadays, however, even if a group wishing to found a bank had little trouble raising the minimum capital required and assuring the authorities of their good faith, they would find it difficult indeed to win a sizable share of the Canadian banking business unless they could rapidly build up a trained staff and a wide network of branches. The amount of capital and the organizational work involved in so doing are surely a far more powerful deterrent than the statutory requirements.

**383.** Historically, the statutory provisions regarding entry into the banking business have contributed to promoting a sound system in Canada. However, times change. Much progress has been made in the understanding of the basic nature of the banking function, the regulation and control of banks, and the protection of depositors. Modern central banking techniques, bank inspection and supervision, and other measures both in Canada and in other countries have brought new disciplines and taught new skills. It is therefore only fair to ask if the arguments for the present entry provisions are still valid in the public interest, for surely it is the public interest that must govern.

**384.** If we look no further than the performance of banks chartered under the Bank Act, there seems to be little justification for modifying the provisions that now apply to entry into the banking business. The need for sound and responsible banking practice is more pressing, not less, in a complex modern society. Many of the techniques devised in other countries to improve and strengthen their banking systems have been in large part to achieve what was already characteristic of Canadian banking; others have already been adopted in Canada; none of them offers any reason for reversing the traditional pattern of our banking legislation. By any objective comparison with other countries, Canadian banking must be rated highly.

**385.** However, if we broaden our view to take in the performance of banking and quasi-banking functions by other financial institutions, a somewhat different picture emerges. Experience over the years has led to the imposition of stringent controls over the chartered banks to ensure that they are soundly operated and that depositors' funds will remain liquid in times of financial crises—special provisions concerning shareholders' audit, rigid internal inspection, and supervision by the Inspector General of Banks; the detailed provisions of the Bank Act in relation to formation, management, and winding up; limitations on the activities in which banks may engage; and so on. This provides a formidable armoury of safeguards under federal legislation. To a somewhat similar extent the same situation, in respect of legislative safeguards, applies in the case of the two institutions operating under the Quebec Savings Bank Act, a federal enactment broadly modelled on the Bank Act. Yet many other financial institutions now hold large portions of the liquid savings of the public under conditions not greatly different from those which applied to banks in the days before the development of modern safeguards to protect the depositor. It may even be that the very success of the measures for assuring strong and sound banks has lulled the authorities and the public alike to the dangers of unregulated banking. Our forefathers had intimate practical experience with these dangers, but this generation has not. In any case the tradition of safety built up by the chartered banks has made it easier for the near-banks to grow without actually having to provide to the public the financial protection that is nowadays taken for granted.

**386.** From the foregoing it can be seen that banking is far from being a monopoly. Indeed it would be hard to think of a typical banking function that is not offered by one or more competitors of the chartered banks. There are many bidders for available funds —governments, insurance and trust companies, savings banks, and credit unions, etc., as well as the short-term investment market.

**387.** On the lending side, too, there are many types of credit available to individuals and corporations for a variety of purposes, much of it in competition with the banks either directly or indirectly. Manufacturers, wholesalers, and retailers extend a large volume

of credit in an informal way in the ordinary course of their business. Finance companies do much of the instalment financing of retail sales of durable goods. Personal loan companies do a large volume of personal financing, much of which is in competition with the banks. Credit unions are playing an increasingly important part in the consumer credit field. Life insurance loans are for the most part based on mortgages, but even mortgage loans are directly competitive with chartered bank lending to the extent that working capital is sometimes provided in this way; loans against life policies are a large and ready source of personal credit, and make the cash loan value of a policy comparable to a savings account in some respects. Trust and loan companies lend money on mortgages and against the security of stocks and bonds. Foreign parent companies and other foreign investors often provide working capital to subsidiary or affiliated companies in Canada. Bond issues, in addition to providing long-term capital for industry, sometimes provide funds for working capital purposes. The Industrial Development Bank supplements the activities of other lenders by providing intermediate and longer-term credit to industry, particularly for smaller enterprises. Money-market operations outside the banking system reach substantial figures; it is estimated that on occasion more than 40 per cent of day-to-day and call loans are obtained from sources outside the banking system. There are various federal and provincial lending agencies operating in the credit field, particularly for the benefit of farmers and other specialized producers.

388. Some of these lenders obtain a portion of their financing from the chartered banks, and to this extent there is duplication in the figures for lending by banks and lending by the other sources here listed. However, a great deal of it represents the lending of bank deposits belonging to these lenders themselves or solicited by them from third parties through the offer of attractive interest rates. One of the great gaps in Canadian financial statistics is in this field of credit operations outside the banking system, for little is known of the activities of other financial intermediaries except on a piecemeal basis and after long delay.

389. Within the banking system proper there is a very effective amount of competition. Considering the very substantial opportunities available outside the banking system, competition for neither loans nor deposits can be said to be seriously threatened. The limitations imposed on the activities of a chartered bank by the Bank Act, together with effective competition from other banks, ensures that even the largest bank cannot gain financial domination over any field of business or industry.

### The Canadian Bankers' Association

390. The Canadian Bankers' Association was established on December 17, 1891. Previously bankers had met as individual members of the Toronto Board of Trade; then during the revision of the Bank Act in 1890 it became clear to them as well as to government officials that a more formal organization was required, similar to those already existing in the U.S.A. and Britain. The voluntary association was superseded by an incorporated body in 1900, in order to give the Association a more formal and official status and to make it obligatory for all new banks to become members. Among other things it was given the power of supervision and inspection over the banks' note issues, in connection with the operation of the Bank Circulation Redemption Fund established by the Bank Act of 1890 to safeguard holders of chartered bank notes.

391. The powers and the semi-official status of an agent of the Government assigned to the Association in 1890 have since lapsed, because the chartered banks no longer have note-issuing rights. Today is has no supervisory or disciplinary powers, and is simply a trade association. Since 1891, however, it has promoted the efficiency of bank employees by educational courses, has published a magazine, and has operated clearing houses across Canada. Legislation and court decisions on banking matters have been scrutinized

and reported on. For many years it has provided cash rewards for evidence leading to conviction for bank robberies.

392. As it operates today, The Canadian Bankers' Association comprises all banks that are chartered by Parliament and to which the Bank Act applies. Membership results as a matter of course from the chartering of a new bank by Parliament. The Bank of Canada is not eligible, nor the Industrial Development Bank, nor the Quebec savings banks.

393. A bank's membership in the Association is exercised by its general manager, and each bank has one vote and one voice. The active head of the Association is its president, elected at an annual meeting in June. It is customary for the president to serve two one-year terms, although this has not always been the case. It is also the practice for the presidency to alternate every two years between the banks with head offices in Toronto and those with head offices in Montreal. There are also four vice-presidents, two from Montreal and two from Toronto. The president is the spokesman of the Association, and as such can speak for the whole commercial banking community within the limits imposed by the rules of the Association. His responsibilities are particularly heavy before and during a revision of the Bank Act. He is assisted in his duties and in carrying out the decisions of the Association by a small permanent staff headed by an Executive Director.

394. The Executive Council of the Association meets four times a year. These meetings are attended by the general managers of the banks or their nominees. Matters of general interest to the banks come up for consideration. The Governor of the Bank of Canada, the Minister of Finance, and the Inspector General of Banks usually confer with the general managers on the day of the meeting on business conditions and monetary matters. The routine work of the Association, however, is carried on by the permanent staff and by various committees formed by representatives of the banks. The Association works primarily in procedural fields of common concern to all banks and avoids fields that are competitive among banks. For instance, it exercises no influence or authority over the lending rates charged by banks. Clearing houses are established in fifty-one cities across Canada and are operated under rules and regulations made by the Association, because all banks are equally affected. Similarly, the Association provides the machinery for foreign exchange transactions among banks, the general principle being that all require the facility equally and there is no hindrance or interference with the competitive position of any one of them.

395. Since banking is under federal jurisdiction, most of the contacts of the Association with government authorities are at the federal level, particularly the Department of Finance. In each province, however, it has legal representation to keep it informed of legislation having an effect on banking. It has sometimes happened, also, that provinces have asked the Association for advice and co-operation on some specific subject.

396. As already mentioned, much of the Association's work is dealt with by committees. Each bank is usually represented by someone versed in the particular field under review; in this way the Association can call upon men of expert knowledge, so that the committees' reports are based on a wide range of experience and training.

## SECTION II

## COMPETITION WITH OTHER FINANCIAL INSTITUTIONS

### The Role of the Chartered Banks

397. The Canadian chartered banks have traditionally been the chief depositories for personal savings and have also been the chief source for most kinds of short-term

business financing and personal loans. In addition, they have long played an important role in government financing as purchasers of Government of Canada securities, and more recently they have provided a foundation for the growing Canadian money market, which depends to a substantial degree on the fact that the chartered banks keep a secondary reserve in the form of day-to-day loans to money market dealers and Government of Canada Treasury bills. Under the National Housing Act, until the going rate of interest went above the maximum permitted the banks, they made a substantial contribution to residential mortgage financing, a field otherwise prohibited by the Bank Act. Since the establishment of the Bank of Canada, monetary policy has also been implemented primarily through the effects on chartered bank operations of variations in bank cash permitted the chartered banks by the Bank of Canada. The operations of the chartered banks are also regulated in detail by the terms of the Bank Act, as well as by certain of the terms of the Bank of Canada Act. Among the key points of these controls are the statutory limitation of six per cent in the rate which may be charged for bank loans, the statutory requirement to hold eight per cent cash against Canadian deposit liabilities, together with the supplementary argeement on secondary reserves, and the prohibition under the Bank Act of acquisition by the chartered banks of certain types of assets, notably conventional mortgages.

**Development of Other Financial Institutions**

**398.** Over the years a considerable number and variety of other financial institutions have developed in Canada in competition with the banks. Although none of these other institutions offers a full range of banking services, each of them has taken on some functions and services of an essentially banking nature. To the extent that these other institutions may have developed by providing services and facilities which for one reason or another the chartered banks did not provide, the result may be regarded as a desirable growth in the range and flexibility of banking and financing services in Canada, although it has also produced problems in the field of monetary policy for which solutions are needed. However, to a very considerable extent these competing institutions have made rapid headway in areas they have taken over under circumstances in which the chartered banks were prevented by legal or other rigidities from competing effectively. It might be pointed out that some of these competing institutions enjoy freedom from income taxation.

**399.** The major functions of a banking nature performed by these other institutions are primarily the acceptance of savings and other deposits in various forms from the community; the provision of loans for a wide variety of purposes; the provision, in some cases, of the equivalent of chequing services, made possible, in practice, by access to the chartered banks' clearing system; provision, in some cases, of safety deposit boxes and other safekeeping services. These functions are performed without the limitations enforced on the chartered banks by the Bank Act, the Bank of Canada Act, and certain "agreed" arrangements with the Government and the Bank of Canada. "Banking" is not defined in our legislation and various possible definitions, from the point of view of economic analysis, are in varying degrees inadequate or misleading. However, from the point of view of monetary policy these institutions are important instruments for the expansion of credit in the economy and, as such, their operations directly affect the success or failure of monetary policies even though they are not, like the chartered banks, directly amenable to control in the interests of official monetary policy.

**400.** Among these competing institutions are credit unions and caisses populaires, finance companies, small loan companies, factoring companies, trust and mortgage loan companies, insurance companies, participants in the short-term money market, provincial government savings offices, and the Post Office Savings Bank. These institutions are all competing actively for the savings or loanable funds of the community, and all have much

greater freedom than do chartered banks in the way in which they can invest such savings and other funds, and therefore in the returns which they can pay to lenders and depositors. Government of Canada Savings Bonds are also a very important savings instrument involved in the general competition for the community's savings.

**401.** Some credit unions and caisses populaires now make "chequing" privileges available, and some of them invite regular business accounts, grant commercial loans, discount paper, and, in short, conduct a general banking business. Their original emphasis was on the granting of small personal loans to fellow members, but they have been moving more and more into the fields of long-term mortgage lending and other investments in sizable amounts. Under Quebec legislation there is no limit as to the interest paid on deposits or charged on loans by the caisses populaires. Credit unions in a number of other provinces are limited in their loan rates to one per cent per month on the unpaid balance.

**402.** It should be particularly noted that co-operatives, credit unions, and caisses populaires have substantial tax advantages. Their interest rates on savings and shares vary and sometimes there are insurance features which would increase the effective rate, but the rates are of the order of three per cent on deposits and three to five per cent on shares.

**403.** Trust and mortgage loan companies also compete intensively for deposits, primarily by offering higher interest rates. They are rapidly extending their network of branches, and some offer chequing facilities against savings accounts. They also accept deposit accounts from which cash withdrawals are permitted, and they offer term guaranteed investment certificates, usually of one-year to five-year maturities. Mortgage loan companies issue debentures in terms of one to five years at interest rates from four to five per cent. A large part of the assets of the trust companies is invested in the form of mortgage loans. Their current rates on mortgages are in the order of $6\frac{3}{4}$ or seven per cent. The rates now offered depositors generally vary from $3\frac{1}{2}$ or four per cent on some types of accounts to five per cent or more on longer-term guaranteed investment certificates, although there is a great deal of variety in the terms and rates offered.

**404.** Two provincial governments, Alberta and Ontario, have provincial government savings offices. These organizations solicit savings, are exempt from income taxes, and in Alberta make loans, including loans against the security of land mortgages.

**405.** Instalment finance companies are primarily in the business of providing loans to buyers of durable goods, both retail and wholesale. The credit they supply is normally short-term and they therefore obtain their funds mainly by short-term borrowing, largely in the form of notes and debentures and bank loans. Bank loans in recent years have supplied a decreasing proportion of these funds. The smaller companies still rely to a relatively greater extent on bank loans, while the larger ones depend increasingly on the role of their own short-term notes to other financial institutions or directly to corporations. The assets of these finance companies are invested primarily in instalment loan contracts, i.e., "retail paper," at interest rates which vary considerably and over which there is no legislative control.

**406.** Small loan companies and licensed money lenders, some of whom report to the Superintendent of Insurance, are engaged mainly in the field of personal instalment loans. They are permitted, under the Small Loans Act, on loans up to $1,500, to make charges as follows on the unpaid balance of a loan: the aggregate of two per cent a month on any part of the unpaid principal balance not exceeding $300, one per cent a month on any part of the unpaid principal balance exceeding $300 and not exceeding $1,000, and one half per cent a month on any remainder of the unpaid principal balance exceeding $1,000. The Act puts no interest ceiling on loans above $1,500 and requires that only those lenders who charge more than one per cent a month on unpaid balances, on loans of $1,500 or less, be licensed.

**407.** Life insurance companies in Canada have very great flexibility in their choice

of assets in which to invest the funds obtained from their policies. They may invest in all types of government guaranteed debt—federal, provincial, or municipal, Canadian or foreign—corporation bonds and preferred stocks, and, within specified restrictions, common stocks. They may make loans on the security of bonds and debentures, shares, mortgages, and life insurance policies. They may invest any portion of their assets in mortgages provided each loan does not exceed 66 2/3 per cent of the value of the real estate covered.

**408.** In dealing with alternative sources of credit Professor R. S. Sayers, a member of the Radcliffe Committee, goes even further. "Nor should we limit the range to firms ordinarily regarded as financial intermediaries. Among firms whose main activity is manufacturing or trading most do a great deal of lending and borrowing: they extend 'trade credit' to their customers and they take 'trade credit' from their suppliers . . . The distinction between banks as creators of credit and other firms as users or intermediaries in the monetary field is if not completely false at least misleading. From the point of view of the pressure of effective demand, the crucial step is that which increases the power to acquire goods and services, on the part of people inclined to exercise it immediately; and banks are by no means the only firms to place this power in the hands of others."[1]

**409.** Another competing institution is the Industrial Development Bank. Established in 1944, it has been expanding its operations significantly in the last year or so. Its original function was the provision of intermediate-term credit for industrial purposes, but it is now widening its activities to every type of business enterprise. Some of its lending business in the last year or two would appear to have been directly competitive with the chartered banks. Its lending rate has gone as high as seven per cent and is currently 6½ per cent, or higher than the rate permitted by law to the chartered banks. The Act setting up the Industrial Development Bank fixes no maximum rate. The I.D.B. has apparently been unimpeded by various periods of tight money. Total loans outstanding at December 31, 1961 were $133.4 million. It is not unreasonable to assume that the ready availability of central bank funds to the I.D.B. even through times of very tight money, together with its freedom in interest rates, has enabled it to attract loans which otherwise might have been accommodated by the chartered banks if they had equal freedom in their operations.

### Access of Near-Banks to Clearing System

**410.** Full details of the arrangements for near-banks' access to the clearing system are set out in an Appendix.

**411.** The banks have given a great deal of careful study to the question of how the ever-increasing volume of cheques and orders can be handled most efficiently, bearing in mind the criteria for their acceptability as a means of payment, which are ease of negotiation for holders and the earliest possible reimbursement to negotiating banks and near-banks, and the need for equitable apportioning of clearing costs. In this respect the banks have been negotiating on the following basis:

(a) All near-bank organizations and institutions that accept deposits and offer chequing facilities to their customers should be required to assume their proper share of the function and cost of clearing the cheques and other instruments which they negotiate and the orders which they permit their customers to draw on them knowing that the banks will be called upon to negotiate most of these orders. To this end the near-banks which have not already done so should be required to provide clearing facilities co-ordinated with the banks' clearing facilities in the manner described below.

[1]R. S. Sayers "Monetary Thought and Monetary Policy in England," *The Banker*, October, 1960, p. 671.

(b) Local cheques and local orders, negotiated locally, would be cleared locally, and settled for through a current account conducted with the main banch of a bank.

(c) Each near-bank would provide central clearing facilities through its central organization, branch, or office (herein called the "central office") at the central clearing point for the province in which the near-bank is located. The central office would conduct with the main branch of each bank at that point a current account through which settlement for orders, cheques, etc. would be made (herein called the "clearing account"), except that where the volume of clearing items does not exceed a suitable limit determined by the local clearing house the clearing account may be conducted with only one bank.

(d) All cheques and other items clearable through banks (except local items) negotiated by near-banks would be sent by the near-bank to its central office at the central clearing point for the province and deposited in its clearing account there, each bank receiving all items payable at its own branches except where a clearing account is conducted with only one bank. The banks accepting the items on deposit will clear them to the points at which they are payable.

(e) Orders drawn on near-banks negotiated by banks (except local orders) will be sent by the bank to its main branch at the central clearing point for the province and, if the near-bank has no central office at that point, the orders will be cleared by the banks to the nearest central clearing point at which the near-bank has a central office. The orders will be charged to the clearing account of the near-bank's central office and the latter will clear them to the offices on which they are drawn.

(f) The banks must recover by way of clearing fees the full cost of handling the orders plus a reasonable margin of profit. If the full cost is not recovered, the effect would be that part of the cost which should be allocated in full to the near-banks and their customers for whose benefit the chequing facilities are provided is shifted to the banks and their customers who would then be paying the cost of the banks' chequing facilities, plus part of the cost of the near-banks' chequing facilities. This would give the near-banks the competitive advantage of being able to offer lower charges or higher interest rates, or both, in order to attract public deposits.

**Clearing at Par by the Bank of Canada**

**412.** This is another point relating to the clearing system on which our comments have been requested.

**413.** In attempting to develop the arguments for and against having clearing undertaken at par by the Bank of Canada, it may be well first to describe the present situation and to emphasize that the reference is capable of several interpretations.

**414.** The banks have already gone a long way themselves towards universal par clearing arrangements. Since June 1960, all out-of-town cheques have been cleared to and redeemed by the drawee banks at their nearest central clearing point (i.e. Halifax, Saint John, Montreal, Quebec, Ottawa, Toronto, Winnipeg, Regina, Calgary, and Vancouver) and each drawee bank, therefore, carries the debt float on its own cheques from the date of settlement until eventual payment. These cheques may be divided into two categories as follows:

(a) Cheques drawn on branch points, i.e., points where both the negotiating bank and the drawee bank are represented.

(b) Cheques drawn on non-branch points, i.e., points where the negotiating bank is not represented.

Cheques in category (a) are accepted at par by the drawee bank. Cheques in category

(b) are accepted by the drawee bank, subject to the following commissions which are deducted from the amounts charged to drawee banks. (The exceptional procedure for cheques to $50,000 and over is a device to reduce the amount of debit float outstanding in the books of the drawee banks and such items are cleared by direct cheque-list to the branch concerned despite the clearing arrangements which prevail for other items.)

| | |
|---|---|
| Cheques up to $5,000 | 5¢ per item, plus 1/10 per cent of the daily total. |
| Cheques over $5,000 to $25,000 | 1/20 per cent minimum $5 each item. |
| Cheques over $25,000 to $49,999.99 | 1/32 per cent, minimum $12.50 each item. |
| Cheques $50,000 and over | No charge. These cheques are charged to drawers' accounts on date of negotiation after advice by wire. |

415. Briefly, therefore, the only cheques which are NOT being exchanged at par as between banks are those on non-branch points (see category (b) above) for less than $50,000.

416. At Bank of Canada points the clearing house manager provides the local agent of the Bank of Canada with a list of the balances due to or by each bank. Each bank confirms the balance direct to the agent, authorizing a debit or credit, as the case may be, to the bank's account in Ottawa. Instructions are then despatched by the agent to Bank of Canada, Ottawa.

417. This settlement is on a par basis from the Bank of Canada viewpoint, all commission deductions and adjustments of any type having been made at the level of the clearing houses maintained jointly by the banks in larger centres and at central clearing points.

418. It would, of course, be to the banks' advantage to avoid the routine labour involved in the collection of inter-bank commissions if this could be achieved without any significant loss in revenue to the individual banks, by reason of the disparity in branch representation, and already the possibility of eliminating this, or substituting a monthly lump-sum inter-bank payment, is being studied. In arriving at a basis for assessment of a fixed monthly payment, consideration will have to be given to the avoidance of involved record-keeping and statistical processes, which otherwise would neutralize any labour-saving achieved. If we arrive at this condition, which would seem to be essential when electronic sorting of cheques materializes, we shall have in effect par clearing as between the banks without intervention of the Bank of Canada at all.

419. If it is the thought that the Bank of Canada might assume in some way the physical handling of the clearing of cheques we cannot see what this will accomplish nor can we see how this would reduce appreciably the cost to the banks of their present clearing operations.

420. There is frequently misconception of the functions of a clearing house in Canada. It must be borne in mind that there is no detailed listing of cheques at the clearing house which is in distinct contrast to the situation in the United Kingdom, where, for instance, items passing through the Town Clearing (London, England) are listed at the clearing house itself, which is specifically equipped for this function. These items represent some 80 per cent of the sterling total of clearings processed by the London Clearing Bankers. A similar situation prevails in the United States where the Federal Reserve banks undertake a quite considerable physical handling of cheques. In Canada, the physical exchange of cheques may take place early in the morning, before the clearing settlement which only occupies a few minutes or, in centres where the banks employ night clearing staffs, even the night before.

421. At present, each bank must sort the cheques it receives on deposit from its own customers into (1) those drawn on its own bank, and (2) those drawn on other

banks, with the cheques of each bank being sorted separately. If the Bank of Canada were to intervene, a bank would still be required to make the same two sorts, although presumably it might not be necessary to sort by individual banks, but if "other" banks' cheques were sent to the Bank of Canada in one block, his would provide only minor relief in the sorting task. If the sort into banks was transferred to the Bank of Canada, it must be assumed that, on completion, the Bank of Canada would merely turn over to each bank the cheques drawn on its own branches. Each bank would then have to sort these cheques by branch. It is inconceivable that the Bank of Canada would attempt to send a cheque list each day to each branch bank in Canada, but it is the branch sort which causes the greater part of the cost of clearing, and there would be little possibility of achieving cost savings by having the Bank of Canada handle only the bank sort. It should be emphasized that almost all the cost of the clearing and transit function occurs within the banks and is incurred to a certain extent in every branch.

**422.** We are unable to see, therefore, how the introduction of the Bank of Canada into the physical clearing processes would do other than cause delays in the handling of negotiable instruments and add considerably to the present cost of clearing. It is noteworthy that the number of items passing through the chartered banks' clearing system is currently at a rate of 614,000,000 per annum. A further important consideration is that one of the probable avenues leading to maximum automation is the centralization of the cheque-handling function and the deposit-accounting function, with some of the processes of both being carried out simultaneously. Since it would be quite inappropriate for the Bank of Canada to be involved in the latter function its introduction into the cheque-handling function would probably inhibit the full development of bank automation.

**432.** In the United States, the physical clearing of cheques is handled in the main, but not exclusively, by the Federal Reserve System, but the two situations are not comparable. Canada has eight chartered banks having access to the clearing system, whereas in the United States there are about 14,000 banks and it is patently clear that some centralized procedure is essential in these circumstances. Even so, any U.S. bank with a branch system carries on its own inter-branch clearing in the same manner as in Canada. In the United Kingdom a physical sorting, listing, and exchange of cheques takes place at the London Clearing House, but this is an organization created by the London clearing banks and there is no intervention by the central bank.

**424.** It has been said, in favour of Bank of Canada participation in the clearing system, that with the introduction of electronic cheque processing, the individual banks could not justify the purchase of the necessary costly machines. If this were the case, and we do not agree that it is, it is difficult to see how similar expenditures should be undertaken by the Bank of Canada in respect of a programme from which it would receive no benefit whatever.

**425.** It is our view that each chartered bank must enter the electronic age on its own, or jointly with other chartered banks, at some time or another if it is to reap the maximum benefits from automation. The intervention of the Bank of Canada would be a pointless addition to the costs of the Bank of Canada itself, and would impede progress by the chartered banks in this direction. To ensure that full advantage is taken of the opportunities afforded by electronic equipment in such areas, for example, as centralized bookkeeping, each chartered bank must have such equipment under (a) its own control or (b) the control of the chartered banks where competition would force an arrangement reasonable from a competitive and cost standpoint.

### Short-term Money Market

**426.** In another field, that of the short-term money market, the chartered banks have been encountering new forms of competition from a wide variety of institutions

engaging in financial operations. An official money market commenced in Canada in 1954 with the offering by the chartered banks of day-to-day loans to money market dealers approved as participants by the Bank of Canada. As grantors of these day-to-day loans, and as the principal investors in Treasury bills and short-term Government of Canada issues, the banks have from the beginning been substantially involved in the official money market. Although they were already full and active participants, they were requested in November 1955 by the Governor of the Bank of Canada to hold, in addition to the prescribed cash reserve of eight per cent of Canadian deposit liabilities, an additional reserve in day-to-day loans and Government of Canada Treasury bills in such amounts that the total of cash, day loans, and bills would average no less than 15 per cent of deposit liabilities for each month. This has meant that the banks do not have the same flexibility as other participants in the short-term money market, and other participants in the market are sometimes in a position to take advantage of the fixed requirements of the banks. This additional requirement also limits the ability of the chartered banks to shift their resources from short-term money market to other investments and loans, if this should seem desirable. Many corporations, either directly or through trust companies, now invest short-term funds in the money market. In many cases these are funds which might otherwise have been left on deposit with the chartered banks. Corporations of sufficient financial standing are also now able to sell their own promissory notes in the money market rather than seeking loan accommodation from the chartered banks. The fact that such corporations have established lines of credit with their bankers naturally strengthens their position in selling their commercial paper in the money market. Finance companies working through money market dealers also attract considerable funds from the money market through the sale of various short-term instruments. This is an alternative to utilizing their lines of credit with the chartered banks. The banks have developed short-term interest-bearing deposit instruments of their own to meet this competition.

427. The development of this aspect of the money market has added considerably to bank costs. In the first place the banks have to face the additional interest expense of their own new deposit instruments. Furthermore, the result of the increasing use of near-banks has seen a rise in deposit velocity and hence cheque handling routine in relation to balances carried.

428. The existence of the money market also affects the banks by producing a lower level of both loans and deposits than would likely be the case if corporations did not "trade" deposits among themselves (providing the central bank permitted both to rise).

429. In effect, then, despite the fact that the banks now operate with an eight per cent cash ratio instead of the former ten per cent, the net results of the growth in the money market may have been harmful to bank earnings rather than helpful. At the same time, the banks are in danger of losing corporate deposits to other financial intermediaries through their inability to offer competitive interest rates. It should also be noted that, while the money market does provide an avenue for short-term financing, it is impersonal in its operation and provides no assured element of continuity for the borrower. Nor does the money market provide those ancillary banking services on which the users of the money market depend, and which still have to be provided by the banks.

430. Nevertheless the chartered banks recognize that the development of the short-term money market has brought advantages to other major participants. The Bank of Canada now has improved facilities for conducting open market operations; the Government is enabled to finance a larger part of its debt at lower rates, much of it necessarily held by the chartered banks as a result of the additional reserve requirement. The money market has also provided profitable opportunities for the official money market dealers, whose operations are based on their access to day-to-day loans at the bank and to last

resort facilities at the Bank of Canada, and for large corporations and other institutions with short-term funds to invest.

### The Competition for Savings

431. An important aspect of the chartered banks' functions is to gather funds from those who have surpluses and to make them available for use in the economy by others. But the chartered banks are only one of a number of competing institutions which act as financial intermediaries and, in a flexible economy, it is inevitable that there will be changes over a period of time. At times new institutions may enter the field and expand operations while other financial institutions decline in importance.

432. In general it may be said that the chartered banks, which accept deposits either repayable on demand or at short notice, are similar to some financial intermediaries, such as trust and loan companies, but considerably different from life insurance companies or pension funds, which include other functions along with the gathering of savings. Factoring companies, for instance, are another type of intermediary. In this case, while they deal with the public as direct lenders, in general they borrow from other intermediaries. In addition, however, there are now other savings media such as Canada Savings Bonds, which are regarded as undoubtedly safe and liquid instruments, in many ways akin to deposits.

433. Competition for the liquid resources of the community has intensified in the post-war years. As shown in Tables I and II, the chartered banks' share over this period has declined from 87 per cent of the given total in 1947 to 74 per cent in 1960. This continuing relative decline is of importance to the chartered banks, and may have serious repercussions on the economy. If this trend had been the result of free and unrestricted competition among the financial institutions involved, the public interest would have been served. This has not been the case, however, as the banks do not enjoy the same freedom as their competitors. The total of chartered bank deposits is regulated directly by the central bank in the interest of contra-cyclical monetary policy. No such direct influence is exercised over deposits in competing institutions. Indeed, during recent periods of monetary restraint, when chartered bank deposits were being held down by central bank action, total deposits in the near-banks continued to expand rapidly. For instance during the two years 1959 and 1960, while chartered bank deposits rose 1.8 per cent, deposits, etc., in the other competing institutions listed in Table I, i.e., Quebec Savings banks, credit unions, government savings institutions, trust and loan companies, mortgage companies and finance companies, rose 27.4 per cent. (Investment by the public in Canada Savings Bonds rose by 24.1 per cent in the same two years.) The banks are at a disadvantage in attracting deposits because of limitations on their ability to pay rates of interest on deposits comparable to those paid by near-banks.

### Implications for Monetary Policy

434. Under present conditions, as competing forms of financial claims grow relative to chartered bank deposits, monetary policy has either to become more broadly directed against the total supply of liquidity or progressively more vigorous on chartered bank deposits in order to bring about a given expansion or contraction of total money expenditure. When monetary policy is restrictive heavy pressure is placed upon the banks which is not shared by other financial intermediaries. Consequently, under these conditions the near-banks can and do expand at a time when the chartered banks are required to restrict their growth. It follows, under these circumstances, that the central bank is forced to be even more restrictive as the chartered banks' relative position declines.

## TABLE I

### OBLIGATIONS OF SELECTED FINANCIAL INSTITUTIONS
($ Millions)

| At year end | 1947 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 | % Increase 1961/1947 | % Increase 1961/1955 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Chartered Banks:** | | | | | | | | | | |
| Canadian Dollar Deposits | 6,446 | 10,848 | 11,162 | 11,407 | 12,690 | 12,279 | 12,921 | 14,186 | 120.1 | 30.8 |
| **Others:** | | | | | | | | | | |
| Quebec Savings Banks—Deposits | 161 | 247 | 252 | 268 | 285 | 282 | 295 | 317 | 96.9 | 28.3 |
| Credit Unions—Shares & Deposits | 206 | 603 | 700 | 787 | 935 | 1,060 | 1,208 | 1,387 | 573.3 | 130.0 |
| Government Savings Institutions——Deposits* | 129 | 188 | 192 | 195 | 201 | 189 | 196 | 208 | 61.2 | 10.6 |
| Trust Companies—Deposits & Certificates | 230† | 597 | 617 | 649 | 825 | 919 | 1,132 | 1,408 | 512.2 | 135.8 |
| Mortgage Companies—Deposits & Debentures | 189‡ | 469 | 500 | 538 | 602 | 672 | 750 | 874 | 362.4 | 86.4 |
| Finance Companies—Notes & Debentures | 60 | 587 | 797 | 935 | 816 | 1,009 | 1,090 | 1,163 | 1,838.3 | 98.1 |
| (Total Others) | (975) | (2,695) | (3,058) | (3,372) | (3,664) | (4,131) | (4,675) | (5,357) | 449.4 | 99.1 |
| Total Above Obligations | 7,421 | 13,539 | 14,220 | 14,779 | 16,354 | 16,410 | 17,592 | 19,543 | 163.3 | 44.4 |

* As at March 31 of following year.

† For only 17 largest companies representing 94 per cent of all trust companies.

‡ For only six largest companies representing 97 per cent of all mortgage companies and the Investors Syndicate of Canada Limited and subsidiary companies.

SOURCE: Bank of Canada *Statistical Summary*.

## TABLE II

### OBLIGATIONS OF SELECTED FINANCIAL INSTITUTIONS

(Percentages)

| At year end | 1947 | 1955 | 1956 | 1957 | 1958 | 1959 | 1960 | 1961 |
|---|---|---|---|---|---|---|---|---|
| **Chartered Banks:** | | | | | | | | |
| Canadian Dollar Deposits | 86.9 | 80.1 | 78.5 | 77.2 | 77.6 | 74.8 | 73.4 | 72.6 |
| **Others:** | | | | | | | | |
| Quebec Savings Banks—Deposits | 2.2 | 1.8 | 1.8 | 1.8 | 1.7 | 1.7 | 1.7 | 1.6 |
| Credit Unions—Shares & Deposits | 2.8 | 4.5 | 4.9 | 5.3 | 5.7 | 6.5 | 6.9 | 7.1 |
| Government Savings Institutions—Deposits | 1.7 | 1.4 | 1.4 | 1.3 | 1.2 | 1.2 | 1.1 | 1.1 |
| Trust Companies—Deposits & Certificates | 3.1 | 4.4 | 4.3 | 4.4 | 5.1 | 5.6 | 6.4 | 7.2 |
| Mortgage Companies—Deposits & Debentures | 2.5 | 3.5 | 3.5 | 3.7 | 3.7 | 4.1 | 4.3 | 4.5 |
| Finance Companies—Notes & Debentures | 0.8 | 4.3 | 5.6 | 6.3 | 5.0 | 6.1 | 6.2 | 5.9 |
| (Total Others) | (13.1) | (19.9) | (21.5) | (22.8) | (22.4) | (25.2) | (26.6) | (27.4) |
| Total Above Obligations | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

435. One way of explaining this phenomenon is in terms of changes in the velocity of circulation of money. The Bank of Canada has very succinctly described this process in these terms.

> While the central bank can influence the quantity of money (currency and bank deposits), there is no fixed relationship between the quantity of money and the rate of spending. At any given moment a varying proportion of the money supply is inactive, lying in dormant deposits, but capable of being activated if sufficient incentive is offered. Rising interest rates and increased efforts by would-be borrowers cause owners of previously inactive deposits to lend them to those who want to make capital expenditures, or other expenditures. The degree of quantitative restriction that would be needed to overcome the increase in "rate of turnover" of deposits is very great in the early stages of a boom (when it is most difficult to adopt a really rigorous policy) but the scope for further activation of inactive deposits diminishes over a period of time.
>
> A special case of credit expansion feeding on the process of activation of inactive deposits assumed significant proportions during 1955 and 1956, namely, a very large increase in the volume of consumer credit, particularly as financed by instalment finance companies and small-loan companies . . .
>
> Finance companies carry on an operation which is in all essentials banking, but are not restrained by changes in monetary conditions. They are able to compete for deposits through the sale of short-term paper in the money market and to raise funds in securities markets, paying any necessary rate of interest for these purposes, for increased interest costs do not appear to deter consumer borrowing.[1]

436. The rise in the velocity of demand deposits in the post-war period raises the question of whether or not there is a long-term trend operating and, if so, where it is headed. Velocity previously approached its present levels in the speculative boom of 1929, then dropped to very low figures immediately after the 1939-45 war. Part of recent increases may, therefore, be considered as simply a return to a more normal level. However, the post-war growth in deposit turn-over has in general followed such a steady upward pattern that there is little reason to believe it will not continue, and indeed its physical limits are somewhat obscure.

437. Studies in the United States suggest there is a close correlation between velocity of demand deposits and business cycles.[2] However, the Report of the Commission on Money and Credit, while acknowledging that non-bank financial institutions have played some role in increasing velocity during periods of economic expansion, concludes that in general the effect is not important.

438. Nevertheless in Canada in 1959 the combined liabilities of credit unions, trust companies, finance companies and mortgage loan companies increased by $461 million, thus enabling them to expand their loans by about the same amount, at the very time when central bank policy was bringing about a *decline* of $411 million in the Canadian dollar deposits of the chartered banks (Table I). The spending of the loan proceeds, together with the successive rounds of re-spending generated by the rise in money incomes thus initiated, obviously involved a substantial volume of bank debits (and a much smaller volume of near-bank debits), but there is no simple or accurate way of determining what the volume was, so the net effect on monetary velocity cannot be readily ascertained. Still, it would surely have been a significant contribution to monetary stability if there had been some way of restraining the expansion of loans by near-banks in 1959. In other words it is the growth of the resources available to near-banks, and the additional lending and spending that this makes possible, that is of importance for monetary policy.

439. This leads into an alternative way of explaining the relative importance of near-banks, which relates to the total liquidity of the community rather than to the velocity of circulation. For example, the Radcliffe Committee suggests the object of monetary policy should be to affect the level of total demand "by altering the liquidity

[1]Bank of Canada, *Annual Report*, 1956, pp. 24-26.

[2]George Garvey, *Debits and Clearing Statistics and Their Use* (Washington 1959), p. 80 et seq.

position of financial institutions and of firms and people desiring to spend on real resources. The supply of money itself is not the critical factor."[3] What was more important in their view was the total supply of liquid assets, including near-money assets of the type mentioned above.

440. Mr. Manning Dacey in his criticism of the Radcliffe Report[4] noted that:

> A community which formerly held only actual money, finding itself in possession of a growing stock of such assets (near-money) would undoubtedly begin to feel more liquid. Its members would feel less need to hold as large balances as before of actual money, be more willing to run down their cash balances, relying on the possibility of mobilizing their assets if the need arose. In traditional terminology, therefore, we should say the growth of liquid assets other than money will tend to raise the velocity of circulation: a given money stock, reinforced by secondary liquid assets, will support a larger volume of spending than the same money stock without such reinforcement.

441. The financial framework in Canada after the Bank of Canada opened for business in 1935 was perhaps suitable to the financial structure of the country at that time and for some years afterwards, when the chartered banks held the liquidity media in the country as shown in Table I. However, it has been shown that in the post-war period other financial claims there listed have developed in competition with bank deposits.

442. Commenting on similar developments in the United Kingdom, Professor Sayers noted:

> . . . restriction of the supply of bank deposits, if long continued, can be expected to become increasingly ineffective as a curb on total demand because the demand for liquidity can be so well satisfied from other sources. Worse than this, restriction of the banks will increase the opportunities for alternative lenders, so that the banks will lose ground to their competitors and the heads the government can hit will become progressively less influential in the behaviour of the economy.[5]

While Sayers' remarks refer to the situation in the United Kingdom his conclusions might also apply to the Canadian scene.

### Discriminatory Restrictions on Chartered Banks

443. There are at present a number of limitations of a discriminatory nature on the activities of the chartered banks and a consequent reduction in the sources of financing available to the public.

444. The six per cent legal maximum interest rate is perhaps the most important of these restrictions which apply only to the chartered banks and not to other financial institutions. This ceiling may once have reflected public attitudes more understandable then than now, when the banks were the only financial institutions of consequence in the country. In present circumstances it is difficult to find a rational explanation for it. A very large volume of bank lending is, in any case, done at rates lower than the legal maximum. This indicates that banks, like other financial institutions, must meet the going rates in each of many areas of financing. The rates charged reflect the cost of money, the nature of the risk, the costs of doing the business, and other relevant factors including the vigorous competition of other banks and other institutions. In some areas of financing the going rates are above six per cent. These rates too reflect such factors as risks and costs but it is quite conceivable that the rates are in fact higher than they might be if chartered banks were allowed to compete at rates which would give them a fair return but which might well be less than is now charged by lenders shielded from such competition. Chartered banks would also, of course, be in a position to pass on to their depositors an appropriate share of any benefits resulting therefrom.

[3]Radcliffe Report, p. 135.

[4]W. Manning Dacey, *Money Under Review* (London 1960), p. 32.

[5]R. S. Sayers, *Op. Cit.*, p. 682.

445. It is noteworthy that the cost to business enterprises of borrowing money from the banks is normally very small in relation to their total costs of doing business, while, on the other hand, the cost of long-term funds from other sources for such projects as, for example, utilities, major plant construction and pipelines, is a decisive element in the total cost and often determines whether or not the project can be carried out. Yet there is a price ceiling on the first category of lending, and an open market without any legal limitation for the second category.

446. The following examples of the rates charged by other institutions as at November, 1961, are instructive:

Insurance Companies, Investment Companies, Trust Companies and other Mortgage Institutions:
- 6¾ per cent to seven per cent or more on mortgages.

Small Loan Companies:
- 1¼ per cent to two per cent per month (range of effective rates of major companies).

Caisses Populaires in the Province of Quebec:
- 6½ per cent to 6¾ per cent and seven per cent (usually including the cost of insurance) on mortgages as well as personal loans.

Credit Unions and Caisses Populaires outside the Province of Quebec:
- one per cent per month on the unpaid balance.

Central Mortgage & Housing Corp. (Maximum rate):
- 6½ per cent on mortgages

Industrial Development Bank:
- 6½ per cent on loans secured by mortgages or liens.

447. Six and one-half per cent is the rate currently being charged by the I.D.B. However, during 1959 and most of 1960 it charged seven per cent. The act setting up the I.D.B., unlike the act regulating chartered banks, sets no maximum rate and allows the I.D.B. complete flexibility to meet changing market conditions. The fact that the Government's bank, whose loans are comparable to many bank loans, has not been limited by an interest rate ceiling is a fair indication of the reasonableness of the case against such a ceiling.

448. The practical impact of the six per cent ceiling was demonstrated most acutely in the summer of 1959. As the Treasury bill rate rose towards six per cent it became theoretically possible for bank customers to borrow at the prime rate and invest the funds in Treasury bills or other short-term securities at a profit. At the same time large business customers, who had been raising funds for short-term working capital in the "street" from non-financial institutions while market rates were lower than the rates charged by the banks, suddenly found that the prime rate of the chartered banks was lower than the cost of "street" accommodation. They therefore approached the banks to draw down lines of credit which often had not been used for months or years, so that the banks found themselves with a sharp increase in the demand for large business loans at the same time that the demand for other kinds of credit was also extremely strong. The six per cent ceiling in this case not only prevented the banks from using the traditional device of raising prices to moderate demand but actually intensified the demand itself.

449. The interest rate rigidity has also had a profound effect on what has traditionally been one of the main features of the operations of Canadian chartered banks, i.e., the attraction of savings deposits. In the last ten years the rate of growth of savings in a variety of competing institutions has been much greater than in the chartered banks.

450. The chief reason has been that these other institutions, since they are able to invest a very substantial proportion of their total assets in higher-yielding investments, notably conventional mortgages, are likewise in a position to pay a higher return on savings obtained from the public. This results in a progressive limitation of the resources available to the chartered banks for lending and investment activities, and in fact makes it possible for funds to be attracted to depositories not subject to adequate safeguards.

451. It is sometimes argued that, provided these other institutions continue to maintain their cash balances in the chartered banks, the only result of this shift of savings deposits is a change in the ownership of the deposits in the chartered banks—with deposits from trust companies, etc., replacing those of individual owners of savings deposits—and that the cash reserves of the chartered banks are in any case regulated by the activities of the Bank of Canada, so that there is no necessary reduction in the lending and investing capacity of the chartered banks as a result of this drain of savings to other institutions. In fact, of course, the decisions of the central bank authorities as to the cash reserves to be allowed the chartered banks, and hence the decision as to the amount of financing the chartered banks are to be allowed to do at any time, must take into account the volume of financing being done outside the banks. If free competition were established between the banks and the other institutions, and if as a result the banks began to attract a growing share of savings deposits, and were in a position to compete for a share of the higher-yielding investments now taken by these other institutions, the decisions of the central bank as to chartered bank cash would undoubtedly take into account the larger requirements of the chartered banks. There is, in short, no way of avoiding the fact that the loss of deposits to competing institutions affects the chartered banks in exactly the same way as the loss of business affects any other commercial institution.

452. The primary and secondary reserve requirements, imposed only on the chartered banks, amounting in total to 15 per cent of deposit liabilities, are a further important limitation on the freedom of action of the chartered banks in their efforts to make the most effective use of their resources in competition with other financial institutions. Cash reserves, as a minimum percentage of deposit liabilities, were originally intended as a safeguard to the depositors, i.e., to the general public. With the present structure of inspection and supervision, both by the banks themselves and by the Inspector General of Banks, appointed by the Federal Government, this is no longer the main purpose of cash reserves. The normal working requirements of the banks would dictate some level of cash reserves whether or not any legal requirements existed. The eight per cent legal cash ratio, however, introduces a rigidity not faced by competing institutions. A further rigidity is introduced by the undertaking to hold secondary reserves in the form of Treasury bills and day-to-day loans to money market dealers in amounts such that these assets together with cash are equal to 15 per cent of deposit liabilities. This is not in a true sense a reserve, since it is not available for use; rather it is a forced investment. Thus, regardless of alternative investment opportunities which may well be more attractive at any particular time, the chartered banks are under the obligation to maintain substantial holdings of normally low-yielding assets. The consequence of these arrangements is that the chartered banks, alone among financial institutions, must pay a substantial direct cost, in the form of lower returns on their assets than would otherwise be available, as part of the current arrangements for implementing the Government's monetary policy and to facilitate, through the money market, the implementation of the Government's fiscal policy. The ability of the chartered banks to compete effectively with other financial institutions is clearly unfavourably affected by their undertaking, based on a formal request from the Bank of Canada, to hold seven per cent in specified low-yielding assets in addition to the legal requirement to hold eight per cent of their assets in cash on which there is no return.

453. These reserve requirements are a basic element in a further restriction on the ability of the chartered banks to compete effectively with other institutions; this is the fact that monetary policy in Canada is implemented by actions which bear directly on the cash position, and hence the financing opportunities, of the chartered banks, and only indirectly, if at all, on the financing opportunities available to competing institutions. Since these other institutions do not have statutory cash reserve requirements and are not bound by the six per cent interest rate maximum, they are able, during a period when

the authorities wish to contract or restrict the growth of credit, to continue to expand their credit operations and to take advantage of whatever may be the prevailing rate of interest. Since the central bank does not have the power to control their operations, even tighter restrictions have to be imposed on the chartered banks in order to keep the total amount of financing in the country within the limit desired by the central bank authorities. This is clearly a serious defect in the arrangements for implementing monetary policy, and one which imposes special costs and restrictions on the chartered banks, substantially limiting their ability to compete effectively.

454. Another important legal limitation on the competitive position of the chartered banks is the prohibition in the Bank Act of investing by chartered banks in mortgages, with the exception of those allowed under the National Housing Act. This prohibition means that the public is largely prevented, when seeking mortgage money, from approaching the chartered banks as one possible source of the funds required. The field is therefore left open to a range of other lenders who are inhibited neither by government regulation nor by the possibility of competitive action by the chartered banks.

**General Conclusion in regard to Competition with other Financial Institutions**

455. What should be the goal of national policy in this whole matter of the type and variety of financial institutions available to serve the Canadian economy? It is our view that the goal should be to have a wide range and great flexibility in the financial services available to the Canadian public; that this can best be achieved by permitting the free play of competitive forces among the various institutions involved, including the chartered banks, without discriminatory restrictions which work to the disadvantage of one type of institution. At the present time the chartered banks are prevented by various legal and institutional rigidities from competing fully and effectively over the whole range of financing activities with the other institutions listed above. This means that the Canadian public, in seeking to satisfy its various financial requirements, frequently finds that for certain of these requirements the chartered banks must be ruled out as possible suppliers. The result is that for a considerable range of financial activity the other institutions are sheltered from the competition which could otherwise be available from the chartered banks and which could not fail to strengthen the position of the Canadian public as it weighs and compares alternatives sources of financing.

456. So far as possible the solution should lie in the direction of allowing free competition and the play of normal market forces as between competing financial institutions. Some regulations and controls there will undoubtedly be, intended either to safeguard the interests of the public or to facilitate the implementation of official monetary and fiscal policies. To the extent that this is practicable and possible, such controls and regulations should bear equally on all competitors in the field. From the point of view of competition with near-bank institutions, the preferable solution to the legal maximum interest rate problem would appear to be to give the banks the same competitive flexibility now enjoyed by the other institutions, i.e., to eliminate the legal maximum. This, particularly if combined with broader lending powers, would permit the chartered banks to compete on equal terms with other institutions now attracting a rapidly growing share of the savings deposits and loanable funds of Canadians.

## SECTION III

## DEBT MANAGEMENT

457. In the period since the Conversion Loan there have been a number of changes in debt management policy and techniques. With a heavy program of deficit financing

and a sensitive bond market, the Government has adopted a policy of offering relatively small issues of shorter-term bonds at fairly frequent intervals. Recent techniques have frequently involved the purchase of a substantial portion of each new issue by the Bank of Canada, and the gradual feeding out of this issue to the market over a period of weeks or months. The open-market selling is offset, in its effect on cash reserves, by open-market buying of Government of Canada issues outstanding having the shortest maturity. This "leap-frogging" technique has proved helpful during a period when confidence in the market was low.

**458.** At present, when a new Government bond issue is offered the banks are assigned relatively small firm allotments of bonds. The initial allotment is based on past performance in the distribution of recent Government issues. The bank is free to divide its allotment of bonds among its investment account, its trading account for distribution to its customers, and its pension fund as it sees fit. The firm allotment may be less than the amount the bank would like to have for its own investment account. On the basis of the primary firm allotment the bank can usually submit a further order up to twice the amount of the firm allotment. On recent issues, however, the amount available for further orders has been much smaller than the orders, and the second allotment has been relatively small. Thus if a bank wants a substantial amount of a new issue it must go to the dealers.

**459.** The main advantage of this system is that more bank transactions go through dealers, who would otherwise be penalized under current conditions, by the fact that the Bank of Canada has taken on some of the secondary distribution of bonds, as well as by the generally smaller commission payable on shorter-term issues. Previously banks received larger initial allotments specifically for their investment accounts, the transactions were done directly with the banks and the dealers did not participate or know how big bank orders had been. (This arrangement was less costly to the Government than the present system, because the banks paid the full issue price for bonds for their investment accounts, whereas at present more bonds are sold first to dealers, who pay a little less than issue price.) The present system appears to be well-suited to current conditions, though it might not work as well if conditions were to change.

**460.** Although we are satisfied on the whole with the way debt management policy has been developing recently, it is open to some criticisms. The "leap-frogging" technique has been accompanied by more or less overt attempts on the part of the authorities to influence the selling behaviour of the dealers by inducing them to withhold new short-term issues from the banks and offer them instead to the non-bank market. This behaviour on the part of the authorities indicates preconceived ideas on their part regarding the appropriate maturity structure of the banks' portfolios.

**461.** It is probably fair to say that the banks are unanimous in deprecating this practice. It is our view that, once the terms of an issue have been decided upon, the market should operate freely in determining its distribution as between bank and non-bank investors. Any other view of the market would imply the creation of rigidities and barriers between different types of investors, which would inhibit rather than assist the growth of an effective market.

**462.** While recognizing that in the short run monetary policy must take some account of the needs of debt management, we believe that the central bank should not manipulate the cash position of the banking system from week to week in order to aid in the distribution of new Government issues. Before 1960 it was the practice of the Bank of Canada to ease bank cash two or three weeks before an issue was to be offered and then tighten up again after the offering; more recently the technique has been reversed, with the Bank tightening up before an issue and easing afterwards. In effect, both these techniques mean using monetary policy, which is designed to work over a period of months, for short-term ends, thus disrupting the market and creating a degree of uncertainty as to the direction of monetary policy itself.

463. On the technical side the Bank of Canada has been accused of erratic behaviour in its after-market operations with those parts of new issues which it has taken up itself. The criticisms relate to the Bank's hours of trading, amounts of bonds offered at different times, and prices quoted. We are inclined to think that the operations of the Bank of Canada are seriously handicapped by being geographically separated from and out of touch with the major markets in Toronto and Montreal. The situation would be improved if the Bank were to maintain senior officers in both centres with sufficient authority to make on-the-spot trading decisions.

464. We believe that the system of Treasury bill auctions has worked well on the whole. In the past it has been suggested that all Treasury bill transactions should be put through dealers, and that banks should not bid directly for bills at the tender. We would not be in favour of such a change, which in our opinion would be detrimental to the maintenance of an adequately broad market. Further, as active participants, the banks require to be familiar with the money market in all its phases, including the assessment of the market itself which is a part of the regular weekly bill tender.

465. The banks do not have uniform views on what constitutes an appropriate structure for the federal debt. Recent experience suggests, however, that the general public at present prefer to hold Savings Bonds rather than market instruments. Some people conclude that most Government financing should be done in the short-term market, with no particular effort to sell longer-term market bonds except by making them available through the Bank of Canada, as has been done during the past two years. Others would argue that there should be regular public offerings of long-term bonds at whatever prices may be necessary.

466. We believe that the Federal debt should continue to be managed by the Department of Finance, using the Bank of Canada in an advisory capacity only. We would not be in favour of setting up an independent body to make debt management decisions. Debt management techniques, however, would probably be improved if either the Department of Finance or the Bank of Canada were to consult banks, investment dealers, and institutional buyers on a regular basis as is done in the United States before the timing and terms of Government issues are decided.

## SECTION IV

## TECHNIQUES OF MONETARY CONTROL

### Cash Management

467. To exercise control over the volume of bank credit, the central bank has only to regulate the supply of bank cash relative to the needs of the banking system for cash. The central bank, through its control of bank cash, can provide the banking system with surplus cash at any given moment, thus permitting the system to expand. Or, the central bank can withdraw cash from the system leaving it with less cash than it requires, thus forcing the system to contract.

468. Technically, control over the banking system could be maintained in this way by the central bank even in the absence of legal or agreed cash requirements. Banks would still have to hold adequate cash for working purposes just as do most other economic units, but presumably would not hold unnecessary idle cash. Central-bank control would be a matter of adjusting the supply of bank cash relative to these working requirements in order to create a cash deficiency or excess so as to encourage the banking system to expand or contract.

469. There may be circumstances in which a central bank finds it awkward to supply or withdraw bank cash exactly as it desires in order to maintain control over the banking

system. Such circumstances may arise, for example, because of debt management considerations or when the bond market is thin or disorganized. At such times a legal cash reserve ratio may assist the implementation of monetary policy.

470. Proposals for tying legal requirements to different classes of deposits, to different categories of assets, or to bank debits are alternative ways of providing for the automatic release or absorption of bank cash with a view to supplementing or replacing discretionary monetary control. It is our view that complicated devices for making monetary policy more automatic do not offer much promise of improving the effectiveness of monetary control.

471. Our view of central-bank cash management techniques is that, in general, they should operate smoothly and continuously and be capable of tailoring cash changes as precisely as possible to fit the day-to-day needs of monetary policy. They are then least disruptive to the normal operations of the banks. From this point of view open-market operations are by far the best technique of central-bank cash management. Recourse to open-market operations, however, requires a well-developed dealer market for financial assets.

472. The Bank of Canada could also manage bank cash in a general way by extending loans to the chartered banks, money-market dealers, and the federal government, rather than by buying and selling securities in an open market. Loans, however, cannot be administered as flexibly as can a securities portfolio, and for this reason central bank lending is best restricted to a last-resort basis.

473. All other techniques of central-bank cash management seem best left for emergency situations in which the state of the money market prevents the use of open-market operations. Such techniques do not work through the market and so are more arbitrary and less easily understood. Under a regime of managed money it is desirable that the methods of management be clear in order to minimize the danger of creating undesirable uncertainties in the minds of the public.

### Other Monetary Control Techniques

474. Recourse is sometimes had to a so-called liquid-asset ratio as a device for central-bank control over the banking system, as for example the agreement by Canadian chartered banks that they will hold a combination of cash, day-to-day loans, and Treasury bills amounting to not less than 15 per cent of their deposit liabilities, computed similarly to the eight per cent cash ratio. As long as the central bank has firm control over bank cash, however, it does not require a liquid-asset ratio in order to regulate the banking system. It is only necessary to fall back on a liquidity ratio for this purpose when the central bank is unable or unwilling to prevent the banking system from adding to its cash reserves by disposing of liquid assets, as can happen when the central bank is committed to supporting government security prices.

475. However, a liquid-asset ratio may be used to restrain the banks from switching out of more liquid assets into less liquid ones, such as loans. Alternatively, such shifts may be discouraged by a sufficient reduction of bank cash through open-market operations. If the market is unable to support the volume of open-market operations necessary for this, a liquid-asset ratio may serve as a useful stop-gap measure; nevertheless the longer-run solution is to develop better markets.

476. It is our view that giving legal status to a liquid-asset ratio is neither necessary nor desirable. Only the holdings in excess of the stipulated minimum can be considered as a true liquid reserve, so an irreducible portfolio of low-yielding assets tends to make bank operations more expensive without benefiting the banks or their customers. Moreover, such provisions tend to be inflexible and slow to change in the face of changing conditions. Indeed there is a real risk that each new credit crisis will bring an increase in the stipulated ratio in order to prevent the banks making use of any cushion of true

liquidity they may have succeeded in building up, with the result that the situation will become progressively worse. It follows that, if expediency dictates recourse to a stipulated liquid-asset ratio, it should be withdrawn as soon as more permanent remedies can be applied.

477. No doubt other ratios besides a cash or liquid-asset ratio could be devised for implementing and aiding control. It is our view that such ratios, like liquid-asset ratios, are not necessary when money markets are adequate to permit the central bank to exercise its control through open-market operations. If the use of liquid-asset or similar ratios cannot be avoided, they should be imposed for only as long as they are needed, and they should certainly not be maintained for so long that they weaken the incentive to develop better financial markets. In short, it is our view that the emphasis in monetary control should be on bettering financial markets for making open-market operations more effective rather than on devising new methods of control.

### Bank Rate

478. **Functions of Bank Rate.** In Canada, "Bank Rate," the minimum rate at which the Bank of Canada is prepared to make loans or advances can, or could, perform two important functions: regulate the access of the money market to central-bank credit; and provide a signal of central-bank intentions.

479. The first function is necessary for times of restraint to prevent the money market from having ready resort to central-bank credit when the central bank is trying to restrict the amount of its credit outstanding. For this purpose Bank Rate must be a penalty rate in the sense that it makes borrowing from the central bank a more expensive way of raising cash than selling marketable financial assets or borrowing elsewhere. This ensures that the market only turns to the central bank for accommodation as a last resort. Such resort is necessary for non-bank money-market dealers when they are unable to finance their inventories of securities through the banks or through any other source. For banks too it is necessary to have access to such a lender of last resort to ensure that they will always be able to comply with the law on cash requirements.

480. The second function of Bank Rate, that of signalling, is especially important at times of major changes or shifts in monetary policy, or at times when there would otherwise be great doubt about whether or not policy had changed. It is the more difficult function to explain. If Bank Rate is to be a signal of anything, it must reflect the actual or intended cost of additional central-bank credit, for intentions must be supported by action if the intentions are to mean anything at all. In this sense Bank Rate can be a sign, with the central bank setting the rate higher when it believes economic conditions warrant higher interest rates in general and setting it lower in the opposite situation. Not only the direction of a deliberate change in Bank Rate but also the level of the rate would be a signal of central-bank intentions. If it were the intention of the central bank to apply monetary restraint, a discretionary action to raise Bank Rate, and to keep it at a higher level than previously, would serve as a signal of intent, and would be especially useful at times when there was any widespread uncertainty about the intent of monetary policy. When a central bank is trying to influence the economy in a particular direction, it makes sense for the central bank to indicate the direction of movement it desires. Such an indication would certainly enable the banking system to respond faster than it now does to the market pressures exerted on it by the central bank.

481. The present method of setting Bank Rate in Canada at 0.25 per cent above the latest weekly average yield on accepted tenders for three-month Treasury bills provides a Bank Rate that functions satisfactorily as a penalty rate. The money-market dealers are assured of a rate which, though involving a penalty, accurately reflects the market. The Rate floats from week to week and in so doing exacts a penalty from dealers who have to borrow from the Bank of Canada that is neither excessive nor insufficient—as it would be

if a "fixed" Bank Rate were respectively high or low relative to market rates. In lending to the chartered banks the Bank of Canada imposes additional restrictions which do not apply on accommodation granted to money-market dealers, and these restrictions add to the penalty exacted from the banks by the floating Bank Rate. These restrictions relate to the borrowing limits, term, and conditions of renewal.

482. **Other Methods of Signalling.** A major disadvantage of the floating Bank Rate as it now operates is that it gives no clear indication of central-bank policy; yet this is a traditional function of Bank Rate—to provide a clear and unmistakeable signal of central-bank intentions. There is no adequate substitute for Bank Rate in the performance of this signalling function. At first glance it might be thought that simple statements of intentions by the appropriate officials would serve as well. While these are extremely useful, they require a good deal of interpretation, especially when they are general and expressed in non-quantitative terms. Furthemore, the multiplicity of objectives that monetary policy may be used to pursue adds to the difficulty of framing simple statements of intentions.

483. Statements that express intentions in quantitative terms might be expected to have a greater impact, but here it is important to distinguish between economic objectives on the one hand and policy indicators on the other. Objectives are external to the central bank and are outside its direct control; policy indicators are internal to the operations of the central bank and so are controlled directly by it. The former are goals which a central bank may seek to attain by means of the policy instruments at its disposal. Such objectives could relate to money supply, bond prices, national income and expenditure, or general prices. It would be possible for statements of intentions to assign a value to such an objective, say the money supply, thus indicating that the central bank was going to try to keep the money supply at some particular level.

484. Specifying figures for objectives that cannot always be fully achieved runs the risk of discrediting the intentions. For example, there is no doubt that in the longer run the monetary authorities can make the money supply what they want, but such precision is not possible in the short run. For this reason, the prevailing level of the money supply, and use of quantitative objectives in general does not make a good signalling device, for it indicates only the success or failure of what monetary policy is trying to accomplish.

485. Specifying figures for policy indicators is another matter, however. The two most significant indicators of this nature are the amount and the cost of central-bank credit. These are more directly controlled by the central bank than the more remote objectives, and statements about either could serve as a signal of central-bank intentions. Thus, the signal could be in terms of the amount of cash reserves that will be made available. It is more usual, however, to post the cost or price at which amounts will be provided rather than to state the amount that will be supplied. A price or a rate takes into account both demand and supply, whereas specifying an amount does not. For this reason a "price" signal is better than an "amount" signal, and hence posting a Bank Rate, in some way, provides a better signal than posting or setting a figure for cash reserves, and it allows more scope for flexibility. Of course, for Bank Rate to be a satisfactory signal, the central bank must endeavour to make the Rate effective by trying to make the cost of additional central-bank credit conform to the Rate specified.

486. **Bank Rate as a Signal.** The basic problem in using Bank Rate as a signal is to retain its function as an appropriate penalty rate without compromising its signalling function. A return to a conventional Bank Rate, which changes only at the discretion of the central bank, may not solve this problem. A Rate fixed to conform to the policy intentions of the central bank might at times be "off the market" so that it would confront the money-market dealers either with too severe a penalty or with an inducement to borrow from the central bank. Yet to move the Bank Rate to correct these technical situations

entails the risk of having such changes misinterpreted as policy changes, when in fact the Rate is only following the market.

487. Having a dual Rate seems a way out. The penalty Rate could float as at present and serve as the Rate at which both money-market dealers and banks receive accommodation from the central bank. The "signalling" Rate would be a discretionary rate fixed independently of the floating rate and fixed at a level deemed appropriate for the times. The fixed Rate might conceivably be used as well for the Rate at which the chartered banks could borrow from the central bank, leaving only the security dealers to borrow at the floating rate. So long as the central bank was trying to make the cost of additional central-bank credit conform to the fixed Rate, the action of the market would keep the floating Rate from ever being far from the fixed Rate. Temporary slippages in monetary control might cause the floating Rate to deviate from the fixed Rate but large or prolonged deviations would be unlikely. Since the fixed Rate would be changed in keeping with the changing needs of monetary policy, there would be no question of the central bank pegging interest rates.

488. Another possibility is to retain the present floating Rate but to alter the spread between the three-month Treasury bill rate and Bank Rate, making the spread more than 0.25 per cent when monetary policy shifts to tightness and less than 0.25 per cent when the policy is to ease. The size of the spread would be the signal of central-bank intentions. It would reflect the penalty imposed on dealers and banks when they borrowed from the central bank, and the reasoning is that the penalty should be more severe when the central bank intends to exercise restraint than when it is trying to keep monetary conditions easy. It can be argued, however, that the penalty should be constant so as not to disturb market relationships. Indeed the proponents of this scheme realize that large variations in the penalty are undesirable. Yet if changes in the spread are restricted to changes so small that they do not significantly affect the severity of the penalty imposed by the central bank, the changes become little more than symbolic. Furthermore, changes in the spread would be open to misinterpretation if by chance market rates and Bank Rate went one way while the spread went the other way. Still, a variable spread would be better than no signal and is worth further thought.

489. Yet another possibility is to retain the floating Rate as a general practice but to substitute a fixed Rate when a signal is required. At all other times when a signal is not required the Rate would be allowed to float. A possible disadvantage of this method is that it might disturb the money market unduly. The authorities might be reluctant to depart from the floating Rate at times for fear that the change in the method of setting the Rate (as distinct from a mere change in the Rate itself) would have exaggerated effects on market psychology.

490. **Impact of the Rate.** The impact of changes in Bank Rate on the activities of the chartered banks could be quite significant even though chartered-bank borrowing from the Bank of Canada is infrequent. To have an impact the changes in Rate must be more than nominal and must be supported by open-market operations or other appropriate cash management techniques. A noticeable change in the Bank Rate initiated by the Bank of Canada would have an indirect cost effect for the banks as steps were taken to make the Rate effective. Money-market conditions would tend to conform to the new cost for central-bank credit and these conditions would affect the cash adjustment and investment policies of the banks, for these policies are very sensitive to money-market conditions. Thus, Bank Rate may affect the chartered banks in terms of costs even though the banks do not borrow from the Bank of Canada and bank lending and deposit rates are not tied to Bank Rate.

491. Changes in Bank Rate, functioning as a signal of central-bank intentions, would serve to augment the cost effects by causing them to act faster on the lending policies of the banks. Once the signal was given, banks would take steps immediately to

ease or to tighten lending policies to conform with the message provided by the signal. That is, knowing in what direction the central bank was trying to drive the banking system, the banks would alter those lending activities less sensitive to money-market conditions in keeping with the monetary policy indicated.

492. The impact of changes in Bank Rate on the activity of chartered-bank customers depends on how sensitive these customers are to money-market conditions and to conditions in credit markets in general. There is no doubt that changes in Bank Rate, made effective by Bank of Canada action, influence the financing and investing activities of many corporations which in turn would influence the activities of smaller customers. As far as cost effects alone are concerned, the activity of bank customers would tend to vary inversely with changes in Bank Rate.

493. It has been argued, however, that changes in Bank Rate, acting as a signal of central-bank intentions, would cause perverse reactions by the public. A rise in Bank Rate would be seen as confirmation of an expanding situation which should be taken advantage of by expanding one's own activity. There is no way around such a difficulty. Expectations of this nature, no matter on what facts they are founded, will often lead to actions contrary to the best interests of economic stabilization. Failure to provide a signal of central-bank intentions will inhibit such perverse reactions in periods of great uncertainty about the state of the economy but it will also inhibit the response of the banking system to monetary policy, thus slowing down the implementation of positive measures to alter the state of the economy.

### Other Communications and Contacts

494. A central bank is responsible for the day-to-day implementation of monetary policy, and it has a corresponding duty to offer full explanations of its policy. The use of Bank Rate as a signal of central-bank intentions does not eliminate the need for frequent and fuller public statements by a central bank about what its monetary policy is at any given time. The complexity of modern financial environments makes it all the more imperative that the maximum of information be provided.

495. The general argument against fuller disclosure seems to be that it would reduce the freedom of action of the central bank. There are times, it is argued, when monetary policy is a matter of probing the market as part of the process of shaping that policy. At such times no firm policy announcement can be made, and to announce what was being done would destroy the usefulness of all exploratory action. This argument would rule out statements about policy in times when the central bank is not embarking on a major shift in policy and is in fact feeling its way. But once a particular policy action has been decided upon there should be a clear statement of what that action is.

496. When more than exploratory action is being undertaken, the argument against disclosure of policy is that it would disturb the money market. A good market requires some uncertainty, and it is feared that a statement of policy would eliminate that uncertainty. The market would know what to expect and would move immediately to whatever price seemed implied by the statement. This, it is contended, would subject the money market to disruptive swings in prices and yields which would serve no useful purpose. The answer to this is that disclosing the direction in which the central bank wishes the banking system to move does not require disclosing the amounts and prices at which the central bank will be operating in the market. Furthermore, such statements can surely be timed to come after the completion of the basic transactions required to affect the banking system.

497. A clear statement of policy may still cause an abrupt change in prices and yields in the money market, but at a time when a major shift in policy is under way a change of this nature is not necessarily undesirable. Such a statement of policy is extremely useful in clearing up any doubts of the banks as to how the central bank wants

them to respond to its pressures. Informing the public as well as the banks on policy also aids the task of the banks in co-operating with the central bank in implementing the policy.

498. In addition to a signal of central-bank intentions and to full disclosure of monetary policy, we believe it is essential that the banks and the monetary authorities continue to maintain close contacts with each other. It is also essential to have close and effective co-operation between the Bank of Canada and the Government of the day. In our view the Government must have the ultimate responsibility for monetary policy objectives, while the Bank must have responsibility for carrying out day-to-day operations within the framework of these fundamental policies.

**Tied or Linked Rates**

499. It has been suggested that bank lending rates be linked or tied to a Bank Rate functioning as a signal of central-bank intentions—that is, a conventional Bank Rate—along the lines of arrangements in England. This is not as desirable as it may seem at first glance. Ideally, bank lending rates should move with market rates and not with a manipulated non-market rate, which is what a discretionary Bank Rate is. By its very nature, Bank Rate at times will move ahead of the market and at other times will lag behind it. Bank lending rates tied to Bank Rate would then be out of line with the market. For full effectiveness it would also seem necessary to include all lenders in the scheme by linking their rates to Bank Rate. It would be inequitable to require chartered-bank lending rates to follow Bank Rate while other lending rates are free to move with the market.

500. It has also been suggested that deposit rates should be tied to Bank Rates, or that there should be a fixed spread between lending and deposit rates. It should of course be noted that market forces would cause bank lending and deposit rates to move more or less together anyway, but tied rates would introduce unnecessary rigidities. Fixing the spread between bank deposit and lending rates while leaving the spread between the borrowing and lending rates of other institutions free would place the banks at a new competitive disadvantage.

501. Further disadvantages stem from the fact that the interest-bearing deposits that would be affected by tied rates substantially exceed the loans that would be similarly affected. The difference between the two depends on the state of the economy; in slack times, all other things being equal, loans will be lower and savings deposits higher than in times of boom. In the absence of compulsion and with complete freedom of movement, the spread that the banks can afford to allow will partly depend on how large the difference is. The greater the excess of savings deposits over loans the less the banks can afford to pay on deposits relative to lending rates and vice versa. Hence, the spread between lending and deposit rates would naturally tend to widen in slack times and to narrow in times of monetary restraint. But this is exactly what is required to help implement a stabilizing monetary policy. In slack times the accumulation of savings deposits tends to be discouraged by a lower rate; in times of boom, the accumulation of savings deposits tends to be encouraged by a rise in the deposit rate relative to lending rates—a rise that would be ruled out by a fixed spread.

502. Introducing a fixed spread between lending and deposit rates would do away with the stabilizing movement in the natural spread between lending and deposit rates. Banks would be reluctant to narrow the spread in times of monetary restraint for fear that this might become the new imposed spread, and they would be unable to widen the spread in a recession. Complete freedom of movement for both lending and deposit rates would ensure not only that depositors shared to the fullest extent possible in the loan revenues of the banks but also that the best interest of monetary policy would be served as well.

### Compensating Balances

503. Requiring compensating balances from borrowers fits into a discussion of interest rates because such a requirement is generally viewed as a means of increasing the effective rate of interest on a loan. This, however, is not necessarily the case. If the compensating balances required were no larger than the working balances ordinarily carried by borrowers, nothing would be gained by requiring such balances. Only when compensating balances are in excess of ordinary working balances would the cost of bank credit to borrowers be raised. But this can be achieved more simply through higher interest rates, which are to be preferred because they state precisely the cost to the borrower. To require compensating balances disguises the true cost of credit to the borrower.

504. It might be argued that compulsory compensating balances would have the advantage of requiring borrowers to maintain balances sufficient to compensate the banks for the activity in their accounts. The best way to achieve this, however, is to levy service charges on all clients, including borrowers, who fail to keep adequate balances to cover the cost of managing their accounts. This permits an individual approach aimed directly at the accounts concerned and is a fairer approach than a uniform provision for compensating balances.

505. Although it would not be practical to impose compensating balances on all borrowers, a case could be made from the point of view of monetary control for enabling banks to require compensating balances from borrowers under lines of credit. Such requirements could be varied according to the state of business and would serve as a substitute for alterations in lending rates. Bank credit would then become more expensive in a boom and less expensive in a recession even though lending rates remained constant. But, again, this seems less desirable from the economic point of view than simply setting interest rates free.

# SECTION V

## STATISTICAL GAPS

506. We have been asked for our views as to the adequacy of statistical and financial information in Canada. The information now made available by the chartered banks on their own operations seems to us fairly comprehensive, but we believe that other financial institutions should be required to produce fuller and more frequent data on their assets, liabilities, and transactions, with due consideration for the problem of comparable valuation. We should also like to see more work done on the savings-investment flow in Canada. This would require better statistics on the sources and uses of funds.

507. Among the figures we believe should be made available are:

(a) The Government's cash receipts and expenditures on a weekly basis for major items and on a monthly basis in detail, also the Government's overall financial statement for the month of March each year, at present missing from the monthly series.

(b) Weekly figures for the holdings of the Purchase Fund, the Securities Investment Account, and the Exchange Fund (including a classification by currencies).

(c) The Bank of Canada's balance sheet as a weekly average of daily figures, and the Bank of Canada's detailed profit and loss statement monthly.

(d) Detailed monthly or quarterly statements of the assets and liabilities of near-bank financial institutions, valued on a comparable basis, and information on the "chequing" operations of these intermediaries.

(e) A monthly or quarterly classification of assets held in trust and administered by trust companies, showing the distribution of these funds by major asset and by currency on an agreed basis of valuation.

(f) Broader coverage of both insurance companies and trust and loan companies, whose operations are now reported on a sample basis by the Bank of Canada.

(g) Weekly figures on the money-market, including dealer positions, transactions, and borrowings.

(h) Figures on direct new issues of securities by provinces, municipalities, and corporations, including parity bonds and money market issues, classified by borrower and by terms of issue including yields.

(i) Resumption of the "Direct Estimate of Personal Savings" formerly published by the Bank of Canada.

## APPENDIX

# THE CANADIAN PAYMENTS AND CLEARING SYSTEM

## PAYMENT INSTRUMENTS IN USE

**1.** The Royal Commission staff has requested a brief summary of the Canadian "payments system." A list of the instruments in use in Canada, with an indication of the annual volume of items in each case where this information is available, follows:

| Items | Annual Volume (in millions) |
|---|---|
| 1. Cheques | 693 |
| 2. Orders drawn on near-banks | 14 |
| 3. Bank money orders, drafts and travellers' cheques | 9 |
| 4. Postal money orders | 50 |
| 5. Canadian National and Canadian Pacific Express money orders | included in (1) |
| 6. Grain tickets | 3 |
| 7. Coupons | 18 |
| 8. Pre-authorized cheques—so far confined to specifically named insurance companies | incuded in (1) |
| 9. Settlements between banks and branches and the Bank of Canada | 11 |
| 10. Collections, i.e., bills of exchange and promissory notes, the proceeds of which are "collected" for customers | 10 |
| 11. Mail and telegraphic transfers | 3 |
| 12. Acceptance of payment of accounts (including utilities, taxes, insurance premiums, etc.) | 19 |
| 13. Standing orders — (customers' instructions to pay at stated intervals) | Not known |

In addition to these items handled in Canadian funds, some 11 million drafts, money orders and cheques in U.S. funds are handled through the system.

### Negotiable Instruments

**2.** Items numbered 1 to 9 inclusive are themselves negotiable instruments and may be presented through the chartered banks' clearing system. Indeed, of the more than 700 million cheques negotiated in Canada per annum some 568 million pass through the clearing system, the remainder being charged to accounts at negotiating branches.

**3.** Item 10, "Collections" is the service provided by the banks in arranging for presentation for acceptance and payment of bills of exchange drawn by creditors upon debtors. The prevailing rates charged by banks for this service are not adequate to cover the costs involved, and it is questionable whether there is a continuing need in Canada for the "inland bill" when it has fallen into disuse in many other advanced countries. Although there does seem to be a general trend away from this type of settlement, it persists in certain industries and in others is unique to specific companies. The most obvious example is the needle trade where the drawing of drafts is traditional and where, in addition, the drafts themselves are pledged as collateral with the banks, which, as a

rule, are prepared to advance funds against them, subject to a margin determined by the standing of the customer. Upon payment of such bills on due date, the bank acting as collection agent remits to the creditor's bank for his credit, by means of a bank settlement which is passed through the clearings.

### Credit Transfers

4. "Mail and telegraphic transfers," Item 11, are transfers of funds made by one branch bank to another, usually at the request of a customer, but not restricted thereto. Item 12, "Acceptance of payment of accounts," is an arrangement entered into at the request of, say, a utility company whereby payment of periodic accounts may be made at a branch bank by the general public. The number of such arrangements is gradually increasing. Both processes 11 and 12 result in settlement vouchers of one kind or another which pass through the clearings.

5. Item 13, as indicated, is a mandate from a customer to his banker instructing him to make certain periodic payments on his behalf. Although such arrangements are provided for in the Canadian system, and are the subject of scheduled charges, this device has not been utilized in Canada to the extent prevailing in England. Within the banking system, the difference in approach between the two countries lies in the clearing process, in that the English system is based on credit transfer while the Canadian system relies on the principle of debit clearings. At this point we should note that the number of transactions financed by debit transfers in Canada is running at 792 million per annum, as compared with 22 million by credit transfer.

6. In England this type of mandate is used to some extent for payment of insurance premiums, and it could be said that Canada has a somewhat comparable arrangement in the "pre-authorized" cheque plan which has been in operation for the past three years. This is a mandate from a debtor to a creditor, in this case an insurance company, authorizing the latter to draw against the bank account of the policy holder, on a monthly basis, for certain specified amounts.

### Near-Banks' Access to the Chartered Banks' Clearing System

7. An important element in the relations between the Chartered Banks and other financial institutions is the provision by the banks of clearing facilities.

8. In Canada, the mediums of exchange and means of payment used by the general public are coin, Bank of Canada notes, and cheques, the latter being used in the great majority of daily business transactions. The acceptability of cheques as a medium of exchange depends upon the ease with which they can be negotiated, either for cash or for deposit, and upon the existence of adequate and efficient clearing facilities whereby negotiating banks can obtain the earliest possible reimbursement for cheques negotiated. Such clearing facilities are provided and maintained by the Canadian banks and settlement between banks is effected through accounts carried with the Bank of Canada by the head offices of the banks. The banks are constantly improving the efficiency of their clearings system by adopting up-to-date methods and are presently formulating plans for the introduction of electronic sorting of cheques.

9. A basic feature of the inter-bank arrangements for the clearing of cheques is that local cheques are cleared locally and all out-of-town cheques are cleared to the negotiating bank's main branch at the nearest central clearing point; there, cheques on other banks are redeemed by the drawee bank which clears them to its branches on which they are drawn. This method, adopted in June 1960, has proven to be highly satisfactory and much more efficient than the former method whereby cheques on other banks were cleared by the negotiating bank to its own branch at the point on which the cheques are drawn and cheques on non-bank points through the central clearing point.

**10.** Cheques, as defined in the Bills of Exchange Act, are bills of exchange payable on demand and drawn on a bank. In addition to these cheques there has grown up in Canada the use of a type of near cheque—more properly termed a payment order—drawn on organizations such as credit unions and caisses populaires, provincial treasury branches and savings offices in Alberta and Ontario, and a growing number of companies in the trust, loan and mortgage field (mainly trust companies). As already indicated, these organizations are not only in aggressive competition with the banks for savings deposits, but most of them also offer an extensive variety of banking facilities and services, including loans (personal, business and mortgage), safety deposit boxes, safe-keeping of securities, money transfers, and "chequing" facilities. The last-mentioned, which is an important factor in enabling these organizations to offer banking facilities comparable to those provided by the banks, is made possible by the co-operation of the banks in extending to these organizations clearing privileges under which orders drawn on them by their customers and cheques negotiated by them for their customers are cleared through the clearing facilities maintained by the banks.

**11.** The clearing privileges referred to above are made available on reasonable terms and conditions (outlined below), subject only to approval by the organization's bankers and the formality of approval by the local clearing house, if any, and The Canadian Bankers' Association. There is no record of clearing privileges having been denied, but no doubt the privileges would be withdrawn in the event of an organization getting into financial difficulties. It should also be noted that a cost analysis has shown that the average cost of handling one item through the clearing system exceeds the 5¢ clearing fee now charged on credit union and trust company orders.

**12.** The volume of orders referred to above handled through the banks' clearing system is very substantial, as indicated by the following estimate for the year 1961 which is based upon the latest figures available:

| Organization | Total Number of orders | Total Amount |
|---|---|---|
| Caisses Populaires—Province of Quebec | 8,000,000 | $ 875,000,000 |
| Credit Unions—Ontario | 275,000 | 46,775,000 |
| —Saskatchewan | 593,000 | 107,626,000 |
| —British Columbia | 393,000 | 76,555,000 |
| —Other provinces | Not Available | |
| Province of Alberta Treasury Branches | 2,600,000 | $ 260,000,000 |
| Province of Ontario Savings Offices | 1,200,000 | 120,000,000 |
| Trust Companies | Not Available | |
| | 13,043,000 | $1,485,956,000 |

**13.** In addition to the heavy volume of orders, the banks also handle for the near-banks the clearing of a comparable volume of cheques negotiated by them for their customers. The terms on which orders and cheques are cleared by the banks are outlined in the following paragraphs.

### Credit Unions (Caisses Populaires) in the Province of Quebec

**14.** Of the 1,424 caisses populaires in the Province of Quebec, 1,234 are affiliated with La Fédération de Québec des Caisses Populaires Lévis, 22 with La Fédération de Montréal des Caisses Desjardins, Montreal, and 168 (which do not provide chequing

facilities) with the Quebec Credit Union League. Central or regional caisses are located in Montreal (two Centrals), Quebec City, Amos, Bic. Joliette, Marie (Gaspé), Metabetchouan, St. Hyacinthe, Sherbrooke and Three Rivers.

15. The following are the clearing arrangements made:

(a) The Provincial Bank of Canada is the clearing bank for the caisses and Centrals at all points where that bank is represented; at other points other banks act as clearing banks.

(b) **Clearing Fee** On orders negotiated by banks a clearing fee of 5¢ per order is charged to the caisse or Central to which the orders are cleared. The usual annual clearing house fee is not applied.

(c) **Local Items**—At all points where there are one or more banks and one or more caisses, local cheques and local orders negotiated locally are cleared locally between caisses and banks, settlement being made either through an account with the clearing bank or by means of settlement vouchers payable at par in Montreal or Quebec City.

(d) **Out-of-Town Orders**—Out-of-town orders negotiated by banks and settlement vouchers referred to in (c) above are sent to Montreal or Quebec City where they are cleared through the clearing bank and charged to the Centrals' accounts. These Centrals clear the orders through the regional caisses where necessary, to the caisses on which they are drawn. The banks pay the Centrals 1/16 per cent on the daily total of orders except those drawn on local caisses at the two clearing points.

(e) **Out-of-Town Cheques**—Out-of-town cheques negotiated by caisses are sent to the Central or regional caisse at the nearest of the ten points where there are Central or regional caisses. The Central deposits the cheques in the clearing bank which clears them at the following rates:

| | |
|---|---|
| (1) Cheques issued by the Government of Canada or the province in which the branch is located | no charge |
| (2) Cheques drawn on accounts at the branch where they are deposited | no charge |
| (3) Grain and creamery tickets | no charge |
| (4) Local clearing items | 2½¢ each after allowing four free items for each $50 of minimum monthly credit balance in the Central's current account. |
| (5) Cheques on outside points: | |
| Up to $5,000 each | 5¢ plus 1/10% on daily total |
| Over $5,000 each | 1/16%, min. $5 on each item |

**Credit Unions (Including Caisses Populaires) in Other Provinces**

16. With few exceptions the 540 credit unions in Ontario, 271 in Saskatchewan and 316 in British Columbia which permit their customers to issue orders have arranged for centralized clearing through the central credit union for the province, viz.:

Ontario Co-operative Credit Society, Toronto
Saskatchewan Co-operative Credit Society Ltd., Regina
British Columbia Central Credit Union, Vancouver

The clearing arrangements in these provinces are the same as for caisses populaires in Quebec, except as noted below. Each credit union outside the central clearing point conducts an account with a local bank through which local orders and cheques are cleared. Out-of-town orders and cheques are cleared through the Central. The Central conducts with each bank at the central clearing point an account to which orders negotiated by branches of that bank are charged and in which cheques payable at branches of that bank are deposited. As there are no regional credit unions, orders are

cleared by the Centrals direct to the credit unions on which they are drawn and the 1/16 per cent charge on out-of-town orders in Quebec does not apply.

17. The 408 credit unions in the Atlantic Provinces, 228 in Manitoba and 232 in Alberta have not made centralized clearing arrangements.

18. In these provinces orders negotiated by the banks are cleared by the banks to the points at which the orders are payable, where they are charged to the credit union's bank account. The credit union pays the bank a clearing fee of 5¢ per order plus $100 annually and, where there is a clearing house, pays an annual fee of $100 to the clearing house. Cheques negotiated by each credit union are deposited in its local bank, which clears them at the following rates:

| | |
|---|---|
| (1) Cheques issued by the Government of Canada or the province in which the branch is located | no charge |
| (2) Cheques drawn on accounts at the branch where they are deposited | no charge |
| (3) Grain and creamery tickets | no charge |
| (4) Local clearing items | $2\frac{1}{2}$¢ each after allowing four free items for each $50 of minimum monthly credit balance in the credit union's current account. |
| (5) Cheques on outside points | regular rates |

### Trust, Loan and Mortgage Companies

19. Although these companies have numerous offices across Canada (226 offices at the end of 1960), no company has yet undertaken the clearing of orders drawn on its out-of-town offices. Orders negotiated by the banks are cleared by the banks to the points on which the orders are drawn, where they are charged to the company's bank account. The company pays the bank a clearing fee of 5¢ per order plus $100 annually and, where there is a clearing house, pays an annual fee to the clearing house, as follows:

| | |
|---|---|
| At Toronto and Montreal | $300 |
| At Vancouver | $150 |
| At all other points where there is an established clearing house | $100 |

Cheques negotiated by a company for its customers are deposited in its local bank, which clears them at the following rates:

| | | |
|---|---|---|
| Local cheques | | no charge |
| Out-of-town cheques: | | |
| $2,500 and under | 1/8%, | min. 20¢ |
| Over $2,500 and up to $10,000 | 1/10%, | min. $ 3.15 |
| Over $10,000 subject to negotiation | | min. $10.00 |

### Provincial Treasury Branches and Savings Offices

20. These provincial government institutions operate branches or offices in their respective provinces, as follows:

| | |
|---|---|
| Province of Alberta Treasury Branches | 154 offices. |
| Province of Ontario Savings Offices | 24 offices. |

Orders drawn on these offices negotiated by the banks are cleared by the banks to the points at which the orders are payable, where they are charged to bank accounts of the institutions. An exception is that orders on Alberta Treasury Branches at non-bank points are cleared by the Treasury Branches at the following rates:

| | |
|---|---|
| For Canadian Imperial Bank of Commerce | 1/10% on daily total |
| For other banks | 5¢ per item plus 1/10% on daily total |

The only contribution by these institutions towards the banks' costs of clearing their orders is an inadequate fee of 1¢ per order (2¢ at a few points) plus clearing house

annual fees at certain points paid by the Ontario Savings Offices, and annual fees totalling only $3,000 in all paid to banks and clearing houses by the Alberta Treasury Branches on 2.6 million orders. The matter of fees sufficient to cover the banks' costs is currently under discussion.

21. Cheques negotiated by Alberta Treasury Branches are cleared as follows. Cheques payable locally are cleared locally without charge. Out-of-town cheques are sent to the main Treasury Branch in Calgary, where they are deposited with the Canadian Imperial Bank of Commerce and cleared at the following rates:

On that bank's branch points .................................... 1/10% on daily total.

On other points ..................................5¢ per item plus 1/10% on daily total.

22. Cheques negotiated by the Ontario Savings Offices are deposited with local banks and cleared by the banks at rates somewhat lower than regular rates to the public.

# INDEX

**to the Submission to the Royal Commission on Banking and Finance, by The Canadian Bankers' Association, July 1962**

NOTES:

1. An asterisk (*) indicates that the item is separately indexed *in detail* under its own name.
2. Immediately following this Index is a List of Tabulations and Charts.

# SUBMISSION OF NEIL J. McKINNON, PRESIDENT, CANADIAN IMPERIAL BANK OF COMMERCE

Appearance January 1963

1. The briefs submitted to the Royal Commission by the Canadian Bankers' Association and by many other groups and individuals have drawn attention to a variety of important problems concerning the financing of economic activity in Canada. It is the purpose of the first part of this submission to focus attention more directly on certain issues which affect in a fundamental way the future of the chartered banks in Canada. These issues also affect the economic and financial interests of the Canadian public, whether as suppliers of savings to financial institutions or as borrowers from such institutions. The point of view adopted here is that the true interests of all concerned, both the public and the various financial institutions, will best be served by developing the freest possible play of competitive market forces. Such competition will compel all those performing financial services of any type to maintain flexibility and adaptability in their operations in order to meet the growing and changing requirements of all segments of the Canadian community. Such competition will also tend towards the lowest economically feasible charges for financial services consistent with the basic elements of cost and risk involved and the highest average return to those who provide the savings which are fundamental to our economic and financial system.

2. The second part of this submission relates to the broadening of certain provisions of the Bank Act governing the issue of new shares of capital stock and to some considerations affecting the investment by the Pensions Funds of the banks in shares of Canadian chartered banks.

## PART ONE

3. At the present time we have in Canada a considerable variety of financial institutions. In addition to the eight chartered banks, there are trust companies, instalment finance and small loan companies, mortgage loan companies, credit unions, Quebec Savings Banks, government savings institutions, life insurance companies, and the short-term money market. In this context, one should also refer to Government of Canada Savings Bonds since they are an important savings instrument directly involved in the competition for the community's savings, particularly when acquired under various instalment plans.

4. Each of these institutions has a role to play in the economic life of the nation, and each has developed, broadly speaking, in response to some need or opportunity which had not been adequately met by existing institutions. To some extent these various institutions have specialized roles to play, but to a growing extent they overlap and compete with one another. This is especially true on the deposit or borrowing side of their operations where they are all in competition for the community's savings. It is also true to a growing degree with respect to the lending or investment side of their operations, that is with respect to the way in which they employ the funds which they obtain. In one way or another, all provide financing to individuals, business, or to government. It would appear, therefore, that all of these financial institutions are engaged in broadly the same category of business, that is, serving as financial intermediaries between those who have funds to lend or invest, on the one hand, and, on the other, those who have requirements for funds for personal, business, or governmental reasons. If this is the case, it would seem that the general terms or conditions upon which they are permitted to do business should be essentially the same and that the limitations imposed on banks which restrict them from offering all types of service of a banking or fiduciary nature should be removed. This would be desirable to ensure that full benefit could be obtained from the forces of competition. In such circumstances, those institutions which meet their customers' needs most efficiently and most economically would flourish, while the less efficient and less adaptable would face problems.

5. In practice, however, the Canadian chartered banks work under certain restrictions and limitations which do not apply to the other institutions. The chartered banks,

alone among financial institutions, are listed as banks in the Canadian Bank Act and they are controlled in all their operations by the terms of that Act, which sets out in considerable detail what they may or may not do.

6. Section 91 of the Bank Act imposes a maximum of six per cent on the rate of interest which may be charged for bank loans. Section 75 prohibits the banks from lending money or making advances on the security of real immovable property. This prohibition has been modified to the extent that the banks may take mortgage security under certain government-guaranteed lending schemes such as the National Housing Act and the Farm Improvement Loans Act. They may also take chattel mortgages in connection with loans to individuals. However, they are still completely excluded from the whole area of conventional mortgage lending, whether for private or business purposes. Under Section 71 of the Bank Act, the banks are also required to maintain a cash reserve in the form of the Bank of Canada notes held by each bank and deposits with the Bank of Canada, such reserves to be not less than eight per cent of the Canadian deposit liabilities of each bank. Under the Bank of Canada Act, the Bank of Canada is empowered to increase this reserve requirement by stages up to 12 per cent of Canadian deposit liabilities. In addition to this eight per cent cash reserve and in the light of the power of the Bank of Canada to increase the reserve requirement to 12 per cent, the banks have further agreed with the Bank of Canada to maintain day-to-day loans to the money market and Treasury bills in such amounts that the total of cash, day-to-day loans, and Treasury bills shall be not less than 15 per cent of Canadian deposit liabilities.

7. These requirements as noted apply only to the eight chartered banks listed as banks in the Bank Act. Under the British North America Act the Parliament of Canada has exclusive power to legislate in respect of *inter alia*

(a) the regulation of trade and commerce;
(b) currency and coinage;
(c) banking, incorporation of banks, and the issue of paper money;
(d) savings banks;
(e) bills of exchange and promissory notes;
(f) interest;
(g) legal tender.

8. While there is some federal legislation affecting other institutions besides the banks, for example, the Trust Companies Act, the Parliament of Canada has not exercised its authority to legislate detailed regulations and restrictions governing these other institutions to anything like the same extent as it has in the case of the banks. When the British North America Act was adopted in 1867 the great bulk of the financial transactions involving dealings in credit of all kinds, the obtaining of deposits from the public, the provision of chequing facilities on such deposits, and the making of loans and investments on the basis of such deposits, took place within the banking system as it then existed, that is within the chartered banks. At the present time, although a host of other financial institutions have developed which carry on business which is essentially of a banking nature, the authority vested in the federal authorities to control these matters has continued to be applied almost exclusively to the banks. This means, in effect, that functions performed under federal jurisdiction in 1867 have now in practice escaped from federal jurisdiction solely because they are now performed by institutions which were unknown or relatively small in size at that time.

9. As a consequence of this situation, financial institutions other than banks have been permitted substantial advantages in seeking both to obtain the community's savings in the form of deposits or loans of one kind or another, and, on the other side of their operations, in their efforts to serve as a source of financing for borrowers of all types. With respect to the earning power of these other institutions, it should be noted that insurance companies, trust companies, and other mortgage institutions are able to invest

a substantial portion of their assets in conventional mortgages at rates in the vicinity of seven per cent and sometimes higher. Small loan companies and licensed money lenders are permitted, under the Small Loans Act, to make charges ranging up to one and two per cent per month on loans up to $1,500, and there is no limitation on the rates charged for loans in excess of $1,500. The Caisses Populaires in the Province of Quebec charge rates ranging up to nine per cent, usually including the cost of insurance, on loans to individuals, and they are also completely free to invest in mortgages of all kinds. Most credit unions outside the Province of Quebec charge one per cent per month on the unpaid balance of a loan. The assets of instalment finance companies are invested mainly in loan contracts at interest rates which may vary considerably but over which there is no legislative control. Turning to two government-established financial agencies, the Central Mortgage and Housing Corporation rates on mortgages is now 6½ per cent, and it has been higher, and the current rate charged by the Industrial Development Bank is 6½ per cent on loans which, it should be noted, are secured by mortgages. The rate of the Industrial Development Bank, an institution subsidized by the taxpayers in that the capital and surplus are provided by the government through the Bank of Canada without any charge for dividends or other returns, has been as high as seven per cent for considerable periods of time, and the Act setting up this government bank specifies no maximum interest rate. The important point to note in connection with these examples is not so much that rates above six per cent per annum can be charged, for there is nothing special or remarkable about the rate of six per cent. Of prime significance is the fact that, unlike the banks, these institutions have flexibility to set their rates in accordance with market forces. If the "going rate" for a particular kind of business moves above six per cent per annum, they are not arbitrarily excluded.

**10.** It should be noted that the elimination of the ceiling on the lending rate charged by banks would not mean that the range of interest rates charged for various kinds of accommodation would be higher. In fact, it would almost certainly mean that a good many of the rates charged for various kinds of transactions would be lower because it would become possible for the chartered banks to compete in new areas which are now effectively shielded from the force of competition from the banks. One example to illustrate this was the entry, a good many years ago, of The Canadian Bank of Commerce into the field of small personal loans to individuals repaid on a fixed and regular instalment basis. This program has made it possible for this bank to extend loans of modest size, for personal purposes, to individuals, many of whom because of lack of security or other risk factors would have had difficulty in obtaining ordinary bank loans and would have been forced to seek alternative sources of financing where the rates, on an annual basis, might have been anywhere from 12 per cent to 24 per cent, or even higher. The personal loan plan of The Canadian Bank of Commerce was set out in considerable detail before the Standing Committee of the House of Commons on Banking and Commerce at its meetings in 1954 preceding the last revision of the Bank Act. While it was made quite clear on that occasion that the effective average annual yield on such loans, on the basis of discounting them at six per cent, was, up to that time, 10.46 per cent, there was little inclination on the part of any of those then concerned with reviewing these matters to argue that the public interest would be better served if these borrowers were forced to seek accommodation at much higher rates from alternative sources. The initiation of this service by one bank also led to the creation of similar services by others. This is of course only an example and it deals with a relatively small proportion of a bank's total business. The point at issue is that the legal maximum ceiling on bank loans, if it ever had any valid justification, related to a much earlier period in our history when banks were virtually the only financial institutions in the country. Any realistic assessment of the present situation must lead to the conclusion that the considerable network of competing financial institutions is now well established and is here to stay. Interest rates

on all classes of transactions should be set in the market by the free play of competition among all the various types of financial institutions. The ceiling on the interest rate which can be charged by one of the competing types of institutions is a relic of the past which does not safeguard any public interest, but, in fact, serves to reduce the amount of competition which non-bank institutions have to meet, and therefore tends to keep some rates higher than they would otherwise be. This seriously restrains the chartered banks in adapting their operations in a flexible and competitive way to meet the changing opportunities and growing challenges of a complex society.

11. The continuing restriction under Section 75 on the right of the banks to take mortgage security has an effect on their operations similar in many ways to the six per cent restriction. The traditional justification for the prohibition of mortgage lending on the part of the banks has been the emphasis on the banks' need for liquidity. The banks must at all times be prepared to meet their deposit liabilities on demand, and they must therefore have appropriately balanced asset holdings which ensure the necessary liquidity. This question was canvassed at the time of the 1954 revision of the Bank Act when the Act was amended in order to permit the chartered banks to give effect to the intentions of the National Housing Act of 1954, which listed the chartered banks as one of the approved lenders under the federal Government's housing program. On that occasion the Governor of the Bank of Canada, Mr. Graham Towers, indicated clearly that in his view the investment in mortgages of a "moderate percentage of savings deposits" would not impair the liquidity of the banks.[1] In reply to a question as to whether he thought the prohibition of direct bank lending on mortgage security should be lifted, Mr. Towers replied, "Yes, and I have felt that way for many years."[2] It is also of interest that Mr. Towers indicated at the same time that in his opinion the holdings of residential amortized mortgages had not been an important element in the difficulties experienced by many United States banks in the early 1930's, and suggested that, in fact, the loss ratio on such assets had been extremely low.

12. To summarize the results of mortgage lending operations by the chartered banks under the National Housing Act from the revision in the Bank Act in 1954 to the end of 1959, mortgages approved by all sources totalled $3,690 million, of which about $1,292 million were assumed by the chartered banks. In addition, substantial portfolios representing mortgages were held and administered for others. These figures attest to the positive attitude taken by the banks towards National Housing Act mortgage lending with the result that very substantial amounts of private funds were made available to this industry at a time when such financing was badly needed. However, the 1954 amendment to the Bank Act to make it possible for the banks to take on National Housing Act mortgages, as an exception to the general and continuing prohibition on mortgage lending, did not take into account the other main rigidity in the Bank Act, the six per cent ceiling. In December 1959 the going rate for mortgage lending under the National Housing Act was raised by the Government to 6¾ per cent per annum, and although the banks had previously suspended such lending temporarily because of insufficient resources at the time, the consequence of the rate change has been that the banks have since been effectively eliminated from the field.

13. This relatively short period of active involvement in mortgage lending did, however, illustrate that the chartered banks could engage in this business in a substantial way without impairment of their liquidity and it also served to give the banks a good deal of operating experience in this area. Over the years some banks have also acquired a considerable experience in the field of conventional mortgage lending through the

[1] The 1954 Proceedings of the Banking and Commerce Committee (regarding Bill 102 to revise the National Housing Act), page 254.

[2] *Ibid.*, page 269.

investment of a portion of their employee pension funds in good quality conventional mortgage loans.

**14.** If the banks were free to charge the going rate for mortgage loans and to acquire mortgages, whether National Housing Act or conventional (that is, if the prohibition in Section 75 was eliminated completely), it seems clear that their experience in this field indicates that they are well qualified to provide their customers with a full range of mortgage loan services without impairment of their ability to continue to participate fully in other lending and investing activities as well. There are many reasons why it would be desirable in the public interest to enable the banks to compete freely in the whole area of mortgage lending. Under existing conditions the mortgage lending field is largely shielded from any competition from the banks, and it would seem only reasonable to expect that the ability of the banks to enter into this field would have the effect on mortgage lending rates which might normally be anticipated from increased competition and an increased supply of available funds.

**15.** It has also been emphasized during some of the hearings of the Royal Commission that there tend to be gaps in the availability of mortgage financing under present circumstances. One such gap relates to term loans of various kinds to small businesses where ability to take mortgage security would tend to make bank financing more feasible. Another example of such a gap is with respect to resale financing of older homes. This is an important area where financing under the National Housing Act is not available, but where some degree of participation by the chartered banks would be both feasible and desirable if the present restrictions were removed. A large volume of total home purchases must necessarily be financed by conventional mortgages. A participation by the banks even of a modest proportion of savings deposits in this field would provide a valuable service to the public.

**16.** It is interesting to note in passing that in the United States national banks at one time were also prohibited from lending on real estate, with the consequence that trust companies, state banks, and savings and loan associations of various kinds developed very rapidly, taking advantage of the preferred position in which they found themselves as the result of this restriction on the national banks. Commencing in 1913, however, the restriction on mortgage lending by national banks was gradually lifted. At the present time, the national banks in the United States may hold real estate loans amounting to 60 per cent of their time and savings deposits. It must be emphasized, of course, that savings deposits are a much smaller percentage of the total deposits of United States banks than is the case in Canada. At the present time in Canada some 60 per cent of total Canadian dollar deposits of the chartered banks are in the form of personal savings accounts or other notice deposits. Comparable "time deposits" for all United States commercial banks are currently equal to about one-third of total deposits. Assuming freedom to do so, the extent of its investment in mortgage assets of all kinds by a particular bank would be a matter of judgment by its management, but it would be unlikely, at least in the early years of such a development, that the assets so invested would exceed 20 per cent, or at most 30 per cent, of the bank's savings deposits. Here again it should be reiterated that the other institutions in this field are well established and well able to meet competition from any source. Nothing that has been suggested here would tend to eliminate them from the field or to reduce their competitive effectiveness. It is only suggested that the banks with their widespread network of branches, located in all areas of the country and not concentrated only in the larger centres, should be in a position to offer mortgage loans, in addition to other forms of financial accommodation, to the Canadian public.

**17.** This conclusion derives also from the traditional nature of Canadian banking. Canadian banks are both savings banks and commercial banks. The total of personal savings deposits in chartered banks at the present time is in excess of $8 billion, and in addition there are approximately $900 million in other notice deposits. In most countries.

such savings deposits normally provide the foundation for housing loans and other longer-term investments. It is scarcely logical now in view of the growth of the financial system that Canada should be perhaps the only country where chartered banks face these restrictions on mortgage lending when Canadian bank deposits include such a remarkably high proportion of savings deposits While it is neither necessary nor desirable for the effectiveness of this proposed measure to envisage any rigid separation of savings deposits from other deposits in looking at a bank's over-all operation, it remains true that savings deposits in the aggregate are a relatively stable and long-term element on a bank's books and it is therefore reasonable and appropriate that at least a proportion of these savings deposits should be invested in relatively longer-term instruments, particularly in conventional and other mortgages. Since the average yield on such investments is somewhat higher than that which can now be obtained on the bulk of a bank's assets, the first consequence of such a move would be greater ability on the part of the banks to pay higher interest rates to the public on savings deposits. If the banks are to continue to offer effective competition to other institutions in the financial field, it is essential that they be in a position to earn higher rates on a proportion of their assets invested in this way so that they may pay competitive returns on savings deposits.

18. When one looks at the relative rates of growth of chartered banks and competing financial institutions, it is clear that, for the reasons already set out, the chartered banks are not progressing as rapidly as the other institutions because of the restrictions imposed by the Bank Act on their ability to compete. The tables included on pages 96 and 97 of the brief of The Canadian Bankers' Association show the steady decline in the postwar years of the share of the community's funds available for savings or investment which have gone into the chartered banks compared with the share going into other financial intermediaries. From 1955 to 1960, the Canadian dollar deposits of chartered banks increased by slightly over 19 per cent. By contrast, in the same period, the shares and deposits of credit unions increased by 98 per cent, the deposits and certificates of 17 trust companies increased by 90 per cent, the deposits and debentures of seven mortgage companies increased by 60 per cent, and the notes and debentures of finance companies increased by 89 per cent.

19. The total savings in 1947 deposited with credit unions, trust companies and mortgage companies amounted to $625 million, and these had grown by 1960 to $3,025 million. The comparable increase of chartered bank notice deposits was from $3,740 million to $7,791 million. During the same period, savings in credit unions as a percentage of the total amount of savings held by credit unions, trust companies, mortgage loan companies and chartered banks, increased from 4.7 per cent to 11 per cent. The comparable increase for trust companies in the same period was from 5.3 per cent of the total to 10.1 per cent of the total, and for mortgage loan companies from 4.3 per cent to 6.8 per cent of the total. These three types of institutions together in 1947 held 14.3 per cent of the total savings deposits held by themselves and the chartered banks. By 1960 their share of this total had grown to 27.9 per cent. During this same period, the share of notice deposits in chartered banks, as a proportion of the total of chartered bank notice deposits plus savings in credit unions, trust companies, and mortgage loan companies had declined from 85.7 per cent to 72.1 per cent.

20. There are obvious difficulties in the way of any attempt to project these trends into the future, using the rates of growth of, for example, the last five years or so, and the figures which result can be taken only as illustrations of the general nature of developments if present trends and existing limitations on the powers of the chartered banks to do business continue. However, using the rates of growth for the period 1955 to 1960, a projection of total deposits and similar obligations of chartered banks, trust companies and credit unions would be as follows:

| | 1960 | 1965 | 1970 | 1975 | 1980 | 1985 | 1990 |
|---|---|---|---|---|---|---|---|
| | | | (millions of dollars) | | | | |
| Chartered Banks | 12,921 | 15,376 | 18,297 | 21,773 | 25,910 | 30,833 | 36,691 |
| Credit Unions | 1,195 | 2,366 | 4,685 | 9,276 | 18,366 | 36,365 | 72,003 |
| Trust Companies | 1,091 | 2,073 | 3,939 | 7,484 | 14,220 | 27,018 | 51,334 |

21. In absolute terms, the chartered banks' share of the savings deposit business is still large, but the significant point is that the rate of growth of other institutions in the field is substantially greater than that of the chartered banks, and the share of the community's total money deposits going into the chartered banks is declining steadily on a long-term basis. A fundamental reason for this trend is the ability of the competing institutions to pay more attractive rates on savings deposits. A complementary reason, no doubt, is that other financial institutions benefit to some extent from the reputation of safety and security built up over the years by the chartered banks. The feeling that savings can be entrusted with complete confidence to the banks has undoubtedly influenced in a favourable way the public's attitude towards placing their savings with other institutions. Thus they benefit to a considerable extent from a climate of public opinion which has been built up over the decades by the record of the Canadian chartered banks.

22. These developments have clear implications for the nation's monetary policy. If the growth in other depositories who offer banking services, relative to the growth of chartered banks, should show the same trend in the years to come as over the past five years the size of the deposit and banking institutions outside the influence of the central bank eventually will become greater than those within it. Based on the trends of recent years this is likely to take place if existing limitations imposed on the chartered banks continue and it would follow that rigidities in the market would impair the free working of the monetary system. Under these circumstances the influence exercised by the central bank in its monetary policy would gradually diminish.

23. The Bank of Canada's obligation, in the very general terms of the preamble of the Bank of Canada Act, is:

> ". . . to regulate credit and currency in the best interests of the economic life of the nation, to control and protect the external value of the national monetary unit and to mitigate by its influence fluctuations in the general level of production, trade, prices and employment, so far as may be possible within the scope of monetary action, and generally to promote the economic and financial welfare of the Dominion."

In practice, the Bank of Canada's only direct control over credit conditions in the country as a whole is its control over the cash reserves of the chartered banks. By virtue of its power to buy and sell Government of Canada securities as well as a number of other market instruments, the Bank of Canada, by its market operations, can add to or subtract from the cash reserves of the chartered banking system as a whole. The operation of the reserve requirements outlined above means that total chartered bank deposits, and consequently total chartered bank assets, can be controlled in size by these Bank of Canada operations. In the words of the brief submitted by the Bank of Canada to the Royal Commission on Banking and Finance:

> "The central bank operates only at the centre of the financial system—the Government securities market and the cash reserves of the chartered banks—and it relies on the impersonal functioning of financial markets to transmit the effects of its policies through the rest of the economy."[3]

At another point in its brief, the Bank of Canada asserts that:

> "A central bank can exert a pervasive effect on credit conditions even though the

[3] The Bank of Canada Submission to the Royal Commission on Banking and Finance, page 21, para. 61.

direct effects of its operations are confined to the cash reserve position of the commercial banks and to the market for short-term Government securities."[4]

24. The fact that the chartered banks are the sole means through which monetary policy is transmitted has various consequences. At a time when chartered bank operations constituted an overwhelmingly large proportion of total financial activity in the country, this may have been justifiable. In present circumstances, however, the ready availability of many alternative sources of credit means that when credit restrictions are applied to the chartered banks, through the mechanism of reserve requirements and the Bank of Canada's market operations, the immediate consequence is that the business done by competing institutions tends to expand to fill the gap. This situation is accentuated by the fact that in a period of credit stringency, with accompanying higher interest rates, the other institutions are not limited by a six per cent ceiling. It cannot be assumed, therefore, that the "impersonal functioning of financial markets" will in fact transmit the effects of the Bank of Canada's policies in an effective or equitable way through the rest of the economy. In fact, a further quotation from the brief of the Bank of Canada might be used to illustrate the rather unsatisfactory nature of this assumption. After describing the possible use of varying the minimum cash reserve or the liquid asset ratio for chartered banks as an additional measure, along with the normal techniques of cash management, to place a restraining influence on excessive demands for credit, the brief contains the following interesting paragraph:

> "Such a policy would not succeed in accomplishing much if the unsuccessful applicants for bank credit merely turned up elsewhere in the market to press their demands for credit. However, there are substantial imperfections and much inertia in credit markets and it is a reasonable assumption that many of the disappointed bank borrowers would either fail to search out and find alternative sources of credit or would be deterred at least in part from pressing their full demands through unwillingness to accept stiffer credit terms."

It is difficult to share the view that a significant number of bank customers would give up so easily.

25. Another aspect of the adverse differential effect on chartered banks of reserve requirements, both cash and liquidity, is the simple effect of these requirements on the banks' earning assets. Alone among the whole range of competing institutions, chartered banks are required to keep an amount of their assets equal to at least 15 per cent of their Canadian deposit liabilities in a form which produces either no income, the cash component, or a relatively low yield, the additional obligatory percentage held in the form of day-to-day loans to the money market and Treasury bills. The banks' true reserves, either in cash or highly liquid short-term assets which can quickly be turned into cash, and which are needed in order to meet the cash demands of our customers, and on which earnings consequently are low, must be in excess of the mandatory 15 per cent, and, therefore, this large amount is not in practice available for use.

26. In the words of the United Kingdom Radcliffe Report[5], the institutions discussed in this brief survey, including the chartered banks, are all:

> ". . . in active competition for funds, and all supply finance to borrowers of different kinds. They make up what we may refer to as 'the financial sector' of the economy, a phrase which emphasizes the importance of examining the activities of each institution in relation to the others and not in isolation from them."

In this section of its report the Radcliffe Committee deals with such institutions as the joint stock banks, insurance companies, pension funds, building societies, investment trust, hire purchase, and finance houses. These are described in the report as ". . . the main groups of institutions in the monetary system whose behaviour can be expected to

[4] *Ibid.*, page 28, para. 18.

[5] Report of Committee on the Working of the Monetary System, page 107.

have appreciable influence upon the facility with which, and the terms upon which, people can obtain finance . . ." and which are ". . . the main channels through which finance passes from lenders to borrowers." A further quotation from the Radcliffe Report is also instructive:

> "We have included all these groups of institutions in one chapter, despite the great differences in the activities which they undertake and the types of credit they offer, because we have been impressed in hearing evidence not by these differences but by the fact that the market for credit is a single market. Though each type of institution has its special type of business and may, by tradition or as a matter of commercial arrangement, state a preference for one form of lending rather than another, it does not seem that any hard and fast lines are drawn, for instance between the supply of short finance and the supply of long finance; and borrowers seem to be ready to switch to some extent from one to another if difficulties are put in the way of their obtaining finance from the source upon which they are accustomed to draw."[6]

In the United Kingdom, of course, there is no comparable ceiling on the interest rate chargeable by banks nor on the kind of security which may be taken and this contributes to a greater mobility and flexibility in the financial system as a whole.

27. These references emphasize the conclusion of the able and distinguished committee of enquiry headed by Lord Radcliffe that all such financial institutions are engaged in fundamentally similar operations. This point of view contrasts sharply with the distinction in Canada between banks and other financial institutions. The distinction is fully understandable on historical and traditional grounds, but in present circumstances it is entirely arbitrary. The legislative position in Canada is such that only the chartered banks are under the controls established by the Bank Act and the Bank of Canada Act, even though many other institutions now carry on essentially similar operations as financial intermediaries of one kind or another. Because of this situation there has already been a good deal of legal argument and discussion as to the definition of banking, one of the subjects on which the federal Parliament has exclusive power to legislate. If banking were defined so as to cover all those institutions which perform the functions of a financial intermediary (and this, is, by implication, the approach revealed in the above citations of the Radcliffe Report) there is little doubt that many of the operations of financial institutions other than banks would come more directly under the jurisdiction of the federal authorities. Indeed, as has been pointed out above, this may in the end be necessary if the Government and its agency, the Bank of Canada, are to succeed in carrying out effective monetary policies. In this connection, another problem which arises is that of compliance with monetary policy by foreign-owned financial institutions. It has been apparent in past periods of credit stringency that, for example, foreign-owned finance companies, having outside sources of funds, have not been under even the indirect restrictions which influence other non-bank financial institutions.

28. For present purposes, however, it is sufficient to make it clear that these other institutions are in various ways in the same business and in competition with the chartered banks. Such competition is welcome and desirable in the broadening of financial facilities available to the public; the development of a range and variety of financial institutions to serve the needs of the public is in itself beneficial. On the grounds of serving the public effectively and of equity, however, there can be a fundamental objection to having one set of these institutions, the chartered banks, subjected to stringent restrictions which do not apply to the other institutions. If these restrictions were in themselves useful and served a valuable public purpose, the logical solution would be to apply these rules as equitably as possible to all competing financial institutions. In fact, however, at least two of the restrictions, the prohibition of mortgage lending and the ceiling of six per cent per annum on the charge for bank loans, serve no useful public purpose and therefore should

[6] *Ibid.*, page 42.

be eliminated. It would indeed be a *reductio ad absurdum* to apply these restrictions to financial institutions in general since mortgage money must come from somewhere and market pressures would inevitably produce other sources of credit where a demand existed that could not be satisfied within the rigid limits of the six per cent ceiling.

29. The question of applying monetary policy to all other financial institutions in a more direct and effective way raises problems which will have to be faced and solved in the long-run interests of the nation. Careful consideration should be given to requiring that variable cash reserves, comparable, in relation to the nature of the business done, to those required of the chartered banks be maintained by all institutions seeking deposits from the public and offering various kinds of banking services. Unless steps to this end are taken, perhaps on a progressive basis and beginning with the larger and more readily controllable institutions, the effectiveness of monetary policy measures undertaken by the federal authorities will probably diminish. Professor R. S. Sayers, one of the members of the Radcliffe Committee, emphasizes this point in an article in *The Banker* for October 1960. He argues that the restriction of the supply of bank deposits as an instrument of monetary policy can be expected to become increasingly ineffective in curbing total demand because the demand for liquidity can be so well satisfied from other sources. He goes on to make the point that as the banks lose ground to other competitors the institutions on which the monetary authorities can exert pressure, that is the banks, will become progressively less influential in the behaviour of the economy. The Bank of Canada brief in the passage quoted above at least implies a similar concern by indicating that in carrying out monetary policy under present circumstances reliance must be placed on so uncertain and dubious a factor as the lack of persistence on the part of disappointed bank customers in seeking accommodation elsewhere.

30. If nothing is done to rectify this situation, both as to the specific prohibitions in the Bank Act and the general burden and operation of monetary policy, the natural consequence will be that the chartered banks will either have to accept a long-term decline in their relative position and competitive impact in the financial sector of the economy, or they will be compelled by competition to seek ways of participating indirectly in the fields which are denied them under present legislation. One sign of this development is already apparent in the share ownership of some of the chartered banks in some of the trust companies. Other signs are the establishment of new organizations under the general supervision of or in association with banks to enter into the field of longer-term lending involving mortgage securities and interest levels in excess of the rate provided in the Bank Act. Under the existing limitations imposed by the Bank Act these developments come about to serve a public demand. The maintenance of a condition under which banks are impelled to seek effective control of other institutions in order to provide indirectly services and facilities which they may not provide directly does not result in the most useful kind of evolution in the financial system nor does it encourage the offering of all the services of which the banks are capable through all their branches in communities, small as well as large, in all parts of the country.

31. The recommendations made in this submission will in my view increase the scope and variety of competitive services offered to the public. This cannot fail to be in the interest of the general public whether as suppliers of savings or as applicants for credit.

## PART TWO

32. The Bank Act includes provisions requiring:

1. That an offering of rights to shareholders to subscribe to new shares must be made at a price calculated under a prescribed formula which has the effect of pricing the new shares at the book value of presently outstanding shares less undivided profits,

2. That all additional shares be offered pro rata to existing shareholders,
3. That, except with the consent of the Treasury Board, a bank may not contribute to any pension fund if any part of the fund has been invested in the capital shares of a bank.

33. Commenting first on Item 1 (paragraph 32), the existing formula compels banks to offer new shares at an abnormally deep discount off market price. This restriction does not apply, as far as I know, to any other type of Canadian corporation raising funds by "rights" method. The historical reason for the restriction appears to go back to the "double liability" feature of bank shares, which was removed from the Bank Act a number of years ago with the discontinuance of currency issues by the banks. There would seem to be no reason why the boards of directors of banks should not have authority similar to that of corporations in establishing the price of new shares. Bank shareholders have, perhaps, become accustomed in the past decade to a deep discount in respect of rights issues, but in the long run the best interests of shareholders are not served by a provision which unduly raises the cost of new capital.

34. Referring to Item 2 (paragraph 32), it is, of course, the general practice of most companies to offer new shares pro rata to existing shareholders and I would suggest that, without altering this basic principle, the powers of boards of directors of banks be enlarged to enable them, subject to appropriate safeguards, to make provision for the issue of additional shares for stock purchase and stock option plans for employees and officers.

35. It is, of course, common knowledge that insurance companies, trust companies, finance companies, and most industrial enterprises all draw from a common source for employees. It is not as widely recognized that competition for promising management talent has become much keener than it once was, due perhaps, to improved screening techniques at initial employment and at each promotion and to more exacting standards for executive capacity and performance. Organizations unable to offer a well balanced and flexible stock purchase plan may find themselves at a competitive disadvantage in attracting potential management talent in view of the growing use of such plans in the business world. The rules and permissible conditions under Canadian income tax law, enacted in 1953, make provision for the granting of stock options to individuals by their employers and a number of corporations have resorted to the arrangement in efforts to attract or retain qualified management personnel.

36. A somewhat parallel situation affecting the national banks in the United States is concurrently being rectified to make them more competitive in the employment market. There the Advisory Committee on Banking to the Comptroller of the Currency recently conducted a comprehensive study of the functioning of the national banking system of the United States, and as part of its findings the Committee has recommended that national banks be empowered to offer stock acquisition plans to their officers and employees under certain safeguards. These safeguards would include approval of individual plans by the Comptroller of the Currency in addition to the normal approval of the directors and shareholders of the bank. A change in regulations authorizing federally supervised banks to offer such plans now is, I believe, scheduled to become effective before February 1, 1963.

37. The problem has another aspect. Stability of employment, health and welfare benefits, pension plans, and various other long established advantages of bank employment in this country have become much more widespread than they once were and no longer offer the degrees of preferences in bank employment that they did some years ago. The benefits the bank provides are evaluated by officers and employees in terms of job security and scope for advancement but this does not always evoke the degree of extra effort that is needed for the highest standard of performance and progress in an increasingly competitive world. Additional incentives in the form of appropriate em-

ployees' stock acquisition plans similar to those successfully used by other corporations in Canada could prove beneficial not only to employees and the bank as an institution but to the users of bank services as well.

38. The provision referred to in Item 3 (paragraph 32) was incorporated in the Bank Act in 1954. The Pension Fund of the bank I represent has never to my knowledge invested in the shares of any of the Canadian chartered banks and for many years the trustees of the Fund held the view that it would be inadvisable to do so on the principle that the assets of the Fund which are administered in trust for its members should not include an investment in the shares of the bank itself. The trustees have in recent years come to the conclusion that this is perhaps too narrow a view and, as it may be that they will seek the approval of the Treasury Board for such an investment, subject to limitations, the Treasury Board might find it helpful to have the views of the Royal Commission on Banking and Finance on this subject in view of its intensive study of the banking system.

39. The reasons entertained in years gone by for not investing part of the resources of the Pension Fund in bank shares were principally twofold: one, that in the event of difficulties in the affairs of the bank, the interests of the members of the Pension Fund might be prejudiced and, two, that the acquisition of a large holding of shares in a bank may give the Pension Fund Trustees an unduly large role at shareholders meetings.

40. In my opinion the growth in strength and stability of the banks has caused the first reason to lose validity and the imposition of normal limitations on the proportion of the assets of the Pension Fund which may be invested in bank shares would cause the second reason to disappear. Moreover, it would be feasible and I think desirable to provide for voting of the bank shares by individual members of the Pension Fund in relation to their relative contributions to the Fund.

41. Our own Pension Fund would not propose to seek approval of a plan which would involve investing in the shares of competing banks nor would the trustees think it appropriate to invest more than a moderate part of the resources of the Fund in the shares of the bank whose employees it serves which we understand is customarily sanctioned. Even a modest limit would not be reached for many years because the yield on the shares at the current market is considerably lower than the average yield available in other forms of investment. The objective would be to gain a gradual enhancement in value as the nation grows and bank services expand. In addition the investment would afford another means for the identification of the interests of bank officers with the progress of the institution.

42. It is, of course, a matter of common knowledge that the investment advisors and trustees of other pension funds regard bank shares as one of the most desirable forms of investment.

SUBMISSION OF
G. ARNOLD HART, PRESIDENT, BANK OF MONTREAL

Appearance January 1963

1. I welcome the privilege of appearing before this Royal Commission and of saying a few words which may, I hope, be in some way or another germane to its deliberations.

2. The thoughtful presentation of The Canadian Bankers' Association has necessarily been voluminous, and no useful purpose would be served by an attempt on my part to re-summarize its contents. My own remarks will, therefore, be confined to only a few points which I regard as rather fundamental to an assessment of the role of the banking function in the economy.

3. A few comments regarding the relationship of the Bank of Canada to the chartered banks may be an appropriate starting point.

4. In my opinion the central bank already has at its disposal an entirely adequate "armoury" of legislatively determined "weapons" whereby it may regulate the aggregate cash reserves of the chartered banking system and thereby regulate the level of bank deposits. Moreover, and for reasons which need not be elaborated, there is no lack of opportunity for frequent contacts of a less formal nature between the central bank and the chartered banks.

5. A legally required cash reserve ratio is, of course, the fulcrum whereby the central bank can directly influence the chartered banking system by making cash scarce or plentiful in relation to the requirements of the reserve ratio as such. In my opinion, the present legally established minimum average ratio of eight per cent, and the statutory method by which the minimum cash requirements are determined for the purposes of this ratio, constitute a good, time-tested workable procedure. The eight per cent level itself does not tie up in cash, and therefore render useless for other purposes, a larger amount than the requirements of prudent banking would, in any event, dictate. The averaging technique is realistic in that it recognizes that quite large amounts of cash come and go each month between individual banks in the system and averaging therefore cushions adjustments which could otherwise be unnecessarily disturbing in their impact.

6. I am well aware that the Bank of Canada is empowered to raise the legal reserve ratio, by successive steps, to a maximum of 12 per cent. I think the Bank of Canada has been wise in not exercising that power and relying instead on open market operations to regulate cash in relation to the eight per cent minimum requirement rather than raising the requirement itself. I would hope this situation continues. The money market is deep and broad enough to permit an adequate volume of open market operations and, in my view, any change in the reserve requirement could only be justified in the event of some great emergency.

7. The secondary reserve in the form of day-to-day loans and Government of Canada Treasury bills is not statutorially determined but exists on the basis of a "gentleman's agreement" between the banks and the Bank of Canada. The legally required eight per cent cash reserve plus the "informal" seven per cent secondary reserve together constitute the minimum 15 per cent liquidity ratio under which the banking system operates. It will be quite apparent, therefore, that the "free" or usable liquidity available to any bank is not the 15 per cent which is tied up partly by law and partly by informal agreement, but the excess over that figure. In my opinion, no useful purpose could be served, and some harm might be done, by endeavouring to crystallize the seven per cent secondary reserve in the form of a legal requirement. To speak very frankly on this point, I have grave doubts of the wisdom of a statutory secondary reserve requirement which would make the banking system a legally "captive market" for Government of Canada short-term obligations. The provision has never been misused in this way but I can see no good reason for establishing a legal basis for potential misuse. Further, I question the wisdom of incorporating in legal form, a provision which it might well prove desirable to modify, possibly at short notice, by agreement between the banks and the Bank of Canada, under some set of circumstances not now foreseen. In short, this is, to my mind, an area in which discussion and mutual agreement between the banks and the Bank of Canada

which has operated excellently up to the present, might well be continued in that fashion.

8. Turning to matters beyond the area of techniques as such, I would suggest that such problems in respect of the relationship of the Bank of Canada to the chartered banks as have arisen in the past have stemmed not from a lack of means of influence, formal or otherwise, but rather from a lack of understanding as to the direction in which, and the purposes for which, influences were being exerted.

9. It is for this reason that I welcomed the return in June last, to a more conventional rediscount rate technique. The dual rate which has been introduced, i.e., a fixed "Bank Rate" applicable to advances obtained by the banks from the Bank of Canada, and the lower of the floating rate, as previously determined, or Bank Rate applicable to accommodation extended by the central bank to money market dealers is a workable procedure which has a great deal to commend it.

10. But leaving techniques aside, the basic principle which has been re-affirmed and re-established is that the central bank does have a responsibility to signal from time to time, to the banking system, and to the money market, its views that a change in the direction of monetary policy is desirable.

11. Regarding frequency of changes in Bank Rate, I should think that a middle ground will be desirable between very frequent alterations on the one hand, and on the other, changes so infrequent that they reflect developments of only very major and critical importance. The danger in the latter case might be that changes, when they were made, would tend to be too large and too late and thus conducive to instability rather than to the processes of smooth adjustment.

12. What I have said to this point perhaps suggests a somewhat broader consideration. I think it could be argued pretty compellingly that here in Canada, especially in the post-war years, there has evolved a kind of "folklore" with respect to interest rates and monetary policy. The central theme of this folklore is that "easy money" with its attendant low interest rates is "a good thing" and that any departure from easy money is "a bad thing" for which somebody, somewhere, somehow, should be blamed. I deplore this "cops and robbers" approach in popular assessment of monetary policy.

13. I certainly do not need to inform this Commission that different situations require different monetary policies and that an "easy money policy" may be beneficial in some circumstances and positively harmful in others. But I do think that there is still room for a good deal of public education in respect of this fact, which while readily apparent to those closely concerned with money policy, does not so readily leap to the eye of the layman.

14. For example, I doubt if, in the past, sufficient stress has been placed on the fact that in boom times adherence to an easy money program, superficially popular though that program may be, can have thoroughly undesirable costs in terms of an inflationary spiral at home and an impairment of our competitive position in world markets.

15. Or to take another example, arising out of very recent experience, maintenance of a fixed exchange rate clearly implies that, at times, monetary policy must give external considerations priority over purely domestic objectives. Indeed, in this respect I would go further and suggest that even with a floating exchange rate it is not possible to operate monetary policy with a bland disregard of the position of the balance of international payments. If the balance of payments is heavily adverse, and if at the same time we are for one reason or another experiencing capital outflow, corrective measures will have to be undertaken. In such circumstances absence of responsibility to maintain an exchange rate may only mean that the necessary unpalatable adjustments of domestic monetary policy may be delayed, and that when they do take place, may be all the greater for having been deferred.

16. There is, of course, room for argument about the timing and duration of any particular phase of monetary policy. But under conditions wherein a trend towards

higher interest rates and attendant monetary restraint is clearly in the national interest, there is, I think, a responsibility on the part of all those who make official monetary policy to tell the Canadian public, frankly and fearlessly, why such a policy is desirable.

**17.** So much for some admittedly broad but, I hope, not entirely irrelevant references to monetary policy as such. I turn now to a few observations regarding the Canadian chartered banks.

**18.** May I make a point at the outset that perhaps does not need to be made at all and that is that the interests of the chartered banks are those of the Canadian community at large. High levels of business activity and employment are in the interests of the Canadian economy; that kind of a business background is very much in the interests of the banks. Any well-run business organization is anxious to preserve and extend its share of the market and to behave itself as a good citizen in ways which will command public approval. The banks have these same objectives. Few, if any, Canadian business enterprises can determine the business environment in which they operate. The banks cannot determine theirs. They can do little, if anything, to create a demand for loans when for one reason or another the demand is sluggish. Furthermore, the ability of the banking system, as a whole, to bring about any significant expansion in its assets and liabilities is at all times, and properly so, subject to the regulation of the central bank.

**19.** It is no secret that in recent years one of the fundamental problems facing the banks has been the matter of adjustment to the concurrent development of an increasingly broad and increasingly sophisticated money market. Along with this we have seen the rapid expansion of quasi-banking functions performed by other financial institutions now referred to in popular parlance as "near banks." As a result of this it is now possible, under presently existing circumstances, for holders of large liquid balances to employ funds in the money market, or in "near banks" at higher rates of interest than the banks can pay. Conversely, it is possible for short-term borrowers of significant amounts to use the facilities of the money market at lower rates of interest than the banks can afford to charge.

**20.** To some extent this situation is the result of forces which may prove to be transitory. Business conditions in Canada have for several years been less active than we wish. New capital expansion by industry has latterly been at a relatively low ebb. One of the consequences of this has been a high degree of corporate liquidity. A good many corporations have therefore had funds available for employment in the money market; but under more buoyant business conditions such funds would be employed by business concerns for the purposes of their own expansion programs rather than being lent to someone else. I mention this only to suggest that under more active business conditions the money market may not prove to have the receptivity and depth which it has displayed in the past year or two.

**21.** In any event, a point which I think needs making is that the function of banking is basically different from surrounding money market activities. The money market is a completely impersonal mechanism. It provides no guarantee of continuity of accommodation or no tradition of long familiarity with a borrower's situation or problems. The borrowing customer of a bank expects, and rightly so, something more than money at a rate. He expects a continuity of service, an intimate knowledge of the nature and problems of his business on the part of his banker and he expects his bank to be there when "the going is rough." Indeed, ironically enough, most of the borrowing that goes on in the "street market" can only take place by reason of the fact that the borrower has a line of credit with his bank sufficient to cover not only bank loans he may have outstanding at the time but also the amount of his commercial paper borrowings. In a very real sense, therefore, the chartered banks stand as banks of rediscount for the commercial paper market. Incidentally, this might indeed create a problem for the banks and for monetary policy generally if, under conditions of monetary stringency, any

substantial amount of the unknown figure of total credit extended in the commercial paper market were suddenly to return to the banks.

22. May I make another and closely related point. Borrowing customers of banks, together with users of the commercial paper market who depend on their banks as lenders of last resort, also depend on the banks for the continuity of banking services, surrounding and ancillary to lending operations, which services the commercial paper market cannot possibly provide. In other words, I suggest that "bank money" is different from "market money"; "bank money" is accommodation plus reasonable continuity, plus services; "market money" is just money. Indeed, much the same can be said on the deposit side. The depositor who "works his money" through the various market media now open to him, gets an interest rate and nothing else, but the banking services upon which he relies still have to be performed by the banks.

23. I do not make these observations in any spirit of complaint. The money market is a fact of life; it is performing a function; and the banks will have to live with it. Similarly, competition from the "near banks" for deposit funds and also in the lending field is equally a fact and one to which the banks will have to adjust.

24. Indeed, I might go further and suggest that the relationship of the "near banks" to the monetary system as a whole raises some pretty fundamental questions from the standpoint of monetary control in that influences exerted by the central bank impinge directly upon the chartered banks and much less directly, if at all, on the activities of the quasi-banking institutions. The implications of this have been explored in great detail in the brief submitted by The Canadian Bankers' Association and I have nothing to add to the very important points which have been brought forward in these respects.

25. Regarding the chartered banking system, however, I would emphasize that in my view a desirable and workable "sorting out" of banking and quasi-banking functions cannot take place unless the chartered banking system has a greater degree of flexibility than is now available to it within the present legislative framework of its operations.

26. I suggest that one of the primary barriers to a more flexible banking system is the legal ceiling of a six per cent rate on bank loans. The brief submitted by The Canadian Bankers' Association has dealt with this matter cogently and at length. I would like to add my own view that, while the concept of a ceiling may have had some validity when the banks were to all intents and purposes the sole source of short-term credit, it has no validity today when banking ought to be conducted under conditions of much greater rate flexibility and must indeed be so conducted if the banks are properly to fulfil their function.

27. I should like to make it clear with all the force at my command that I am not advocating the abandonment of the rate ceiling with the thought that "if only the ceiling were removed the banks could make a lot more money." The banks do have a sense of responsibility in this regard and even if that were not the case, competitive forces would be a most effective barrier to any misuse of rate flexibility. In my opinion, abandonment of the ceiling would accomplish four major and desirable objectives:

First, it would permit the banks to assume a reasonable proportion of credit risks, some of them of longer than conventional term, which cannot be now undertaken at the ceiling rate.

Second, flexibility in the respect just mentioned would, I think, also be a potent force in reducing the level of rates in respect of a wide area of lending now going on outside the banks.

Third, greater flexibility on the side of rates charged would also permit greater flexibility in respect of rates paid by way of interest on deposits.

Fourth, the flexibility so achieved would be a two-way matter permitting more rapid response to underlying monetary conditions, by way of reductions in lending

rates as well as of increases.

28. The question of rate is, however, only a part of this matter of increased flexibility. It is a curious anomaly of existing banking legislation that whereas a bank may acquire, by way of an investment, a mortgage obligation of a corporation, it cannot take mortgage security in the ordinary course of its lending business. Similarly, the conditions under which a bank may acquire chattel mortgage security are now so limited as to render this important form of security unavailable to the banks in respect of commercial lending.

29. In brief, and without going into greater detail, I would hope that the next revision of the Bank Act will reflect a thorough house-cleaning of limitations on the banks' lending powers with a view to broadening the area of usefulness of the banking system in the present day economy.

30. My own recommendation would be that, among other changes that should be made, the banks should be permitted to take mortgage security as a matter of course, such permission to include the power to acquire first mortgages on residential property outside the aegis of the National Housing Act.

31. I should perhaps make it clear that in recommending broader and more streamlined lending powers for the banks, I do not visualize that the nature of banking assets would be fundamentally altered thereby. At a time of intense competition there is always the temptation to believe that all would be well if one could only do the business that other people are doing. Specifically, I have no sympathy with the view sometimes put forward that "the way for the banks to compete with the trust companies is to get into the trust company business." Nor do I visualize if the banks are empowered, as in my opinion they should be, to acquire residential mortgages outside the confines of the National Housing Act, that the banks would or could supplant, to any major extent, other institutions for which such mortgage lending is a primary concern.

32. It is, in my view, a false assumption that the banking system will always, and under all conditions, have sufficient resources at its disposal to do, in a big way, every kind of lending business that might conceivably be thought of as an addition to the banks' present powers. For one thing, the kind of over-all credit expansion that this might involve could be far beyond the limits which a properly conducted national monetary policy would indicate. In my opinion, the banks should have the widest possible area of flexibility in respect of their lending powers in order to look after special situations. But I would envisage that the banks would always have to observe some degree of priority in the manner in which their resources were deployed. In summary, it is my belief that the primary lending function of banking is to look after the short-term borrowing requirements of businesses and individuals.

33. Beyond that area there are peripheral lending functions which I believe the banks could usefully perform to the extent that national monetary policy is prepared to see the assets and liabilities of the banking system expand, and also to the extent that the resulting change in the nature of bank assets would be consistent with the nature of the deposit liabilities which the banks assume. In other words, no very useful purpose would be served by the banks, for example, doing mortgage business at the expense of commercial lending which needs to be done and should be done, and which, if not done by the banks, will be done elsewhere in the financial system.

34. I think this is something that needs saying because of the disposition of the public occasionally to overlook the fact that the soundness of Canadian banking institutions, which is rather taken for granted, depends in the final analysis on an adequate degree of liquidity in banking assets. Bank deposits are to all intents and purposes demand obligations and banks must govern themselves accordingly. I am quite prepared to believe that, partly by reason of tradition and partly by reason of legal limitations of the nature I have been discussing, Canadian banks may have in the past been a little

prone to over-emphasize the liquidity feature. But to maintain, as I do, that the banks should have room to take on a modest proportion of longer term less liquid obligations is a far cry from suggesting that fundamental concepts of liquidity are now of little value and of no account.

35. I trust that these observations may be of interest to you as additional background to the more specific discussions which have already taken place. Should you wish to put any questions arising out of my comments I shall be glad to answer them to the best of my ability.

SUBMISSION OF
W. EARLE McLAUGHLIN, CHAIRMAN AND PRESIDENT,
THE ROYAL BANK OF CANADA

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Appearance January 1963

1. I am most grateful to the Chairman and to the other distinguished members of the Royal Commission for this opportunity to express my views. In presenting a separate brief, I do not wish to give the impression that this is some kind of dissenting "minority report" in which I take issue with the brief already presented to the Commission by the President of The Canadian Bankers' Association on behalf of all the banks. Instead my purpose is to emphasize and to elaborate on certain points already raised in the CBA brief.

**Goals, Controls, and Competition**

2. The financial system of any country must be regarded as one of the means towards the attainment of certain broad social or national goals of policy. One of these is closely associated with the traditional definition of "the" economic problem: the goal of an optimum (or most efficient) allocation of the nation's resources of labour, capital, and enterprise. Emphasis on this goal leads to emphasis on the importance of the free market mechanism, and to the general principle that, where policy alternatives exist, the choice should go to the one which involves the least (public or private) interference with the free competitive market. Moreover, to the extent that we achieve this goal in the broad area of finance covered by this Commission, we shall make a contribution not only to the efficiency of our financial system but to the attainment of other goals, more specifically identified with monetary policy, which enjoy so much current popularity. I refer of course to "full employment," "economic growth" and the other goals, usually expressed in aggregates or averages, which the CBA brief quite properly lists among the important objectives or achievements of a properly functioning monetary system.

3. We should, however, distinguish between controls which, like monetary policy, are directed towards aggregates (such as the money supply) leaving competition and private decision-making free, and those which, like price ceilings or floors, are directed towards particular industries or sectors of the economy, inhibiting competition and private decision-making in the industries or sectors affected. As a general principle the latter type, i.e. specific controls and prohibitions, should be rejected in a predominantly free-market economy. Of course exceptions are inevitable: even monetary policy usually involves some specific interference; e.g., cash or liquidity reserve requirements may limit banks' freedom to allocate their assets to the best advantage. But more important still in this context, these specific requirements and prohibitions (even the apparently inevitable ones) interfere with and reduce the effectiveness of monetary policy. All who propose the extension or retention of such specific controls over the working of the financial system, or over other parts of the market economy, should be required to bear the burden of proof.

4. Over the years, banks in all countries have become subject to extensive government regulation of the second variety; i.e., specific control over the nature and distribution of bank assets and liabilities. Some existing regulation originally arose to correct abuses in the early days of banking; other regulation seems to have derived from a general anxiety lest so important a sector of the economy might not always operate in the public interest. Presumably the public interest, which is seldom defined, includes in this case the welfare of depositors, shareholders and borrowers who are directly, though by no means exclusively, affected by the soundness and efficiency of the banking system. Moreover, the soundness and efficiency of the banking system is prerequisite to effective monetary policy and hence to the broader objectives which that policy is designed to achieve. In what follows I shall argue that the public interest in the sense defined is best served by substituting wherever possible a competition for regulation in the market for money and credit, and that this requires the removal of special advantages or handicaps that discriminate for or against any part of the financial system.

### Definition of a bank

5. The removal of a multiplicity of specific controls over the nature and distribution of bank assets or liabilities may have an incidental advantage in simplifying the problem of defining what is and what is not a bank. Definition assumes practical importance if we apply specific controls of this nature to what we choose to call "banks" but do not apply them to what we choose to call "non-banks," or if we exempt what we choose to call "banks" while imposing certain specific controls on what we choose to call "non-banks." An inaccurate or inappropriate definition would then result in unfair discrimination (or at least discrimination not intended by the legislation) against one group or the other. If we free both groups from specific regulation of this sort, the practical necessity for detailed definition is at least open to doubt.

6. Banks could then be "defined" in terms of over-all monetary control: banks would be those institutions which, for the convenience and efficiency of monetary policy, keep their clearing accounts in the form of balances with the Bank of Canada.

7. The chartered banks form what we might call an "optimum clearing area" within the economy. Because of the high mobility of funds within the group, the size and frequency of the flow of funds, and the general acceptability of credit instruments representing claims on banks, the ends of monetary policy are furthered by treating the banking group in a special way: that is, as a means through which monetary policy reaches the economy as a whole. Other institutions accept deposits and make loans and, where mobility of funds exists within a group of these institutions, they may form a separate clearing area. But ultimate settlement of claims for these clearing areas, as well as for unaffiliated institutions, is made through the chartered banks. Like the banking group, these non-bank clearing areas have a certain internal uniformity in cash needs, in their response to changes in cash, and in the size and frequency of fund flows within the group. However, because of the nature of their business, they differ in each of these respects from the banking group; and net flows in and out of the banking group are small relative to flows within the banking group. At the present time, therefore, the convenience and efficiency of monetary policy would in no way be furthered by including these institutions (or similar but unaffiliated institutions) in the banking group which have clearing accounts with the Bank of Canada.

### The Role of Monetary Policy

8. To suggest that we should move towards competition rather than regulation in financial markets is not to suggest that over-all monetary control be diminished, relaxed or eliminated. The use of open-market operations by the Bank of Canada to increase or decrease chartered-bank cash is compatible with full financial competition. The active part of this cash takes the form of chartered-bank deposits with the Bank of Canada and is in fact an economic variable of great significance in the economy. It is the one variable in the financial system that is affected neither by the profit motive nor by impersonal market forces; i.e., it is varied solely at the discretion of the Bank of Canada. By expanding or contracting this variable the Bank of Canada can, through a process familiar to the Commission, expand or contract chartered-bank deposit liabilities which in turn make up almost 90 per cent of the total money supply.

9. In effect then Canada's money supply (defined as the total amount of chartered-bank deposits in Canadian currency plus Bank of Canada notes and Canadian coin in the hands of the public) is, except for purely temporary aberrations, completely responsive to Bank of Canada policy. However, the Bank does not, under present conditions, have effective control over what might be called "money-supply substitutes." These include deposits in various institutions such as trust companies, caisses populaires and credit unions, as well as a wide range of other claims issued by these and other financial institutions. This whole complex of institutions may be conveniently identified by the

simple descriptive term "near-banks."

**10.** The competitive aspect of these operations, as seen by the chartered banks, has already been fully covered in the main CBA brief. I would like in what follows to emphasize the implications for the monetary authorities not only of the growth of the near-banks but of a number of interrelated rigidities and imperfections, all of which work together to reduce the efficiency of monetary policy.

**Making Monetary Policy More Efficient**

**11.** The efficiency of monetary policy will tend to decrease to the extent that money-supply substitutes provided by near-banks grow relative to the money supply proper. Such growth has in fact been artificially stimulated, and the efficiency of monetary policy correspondingly reduced, by certain special rigidities; and here I refer specifically to the six per cent ceiling on bank loan rates of interest and the incidence of statutory and regulatory reserve requirements.

**12.** I do not wish to suggest that the growth of near-banks means that chartered-bank deposits are in some sense being "drained away." Near-bank growth does not of itself reduce the absolute size of the banking system. Initially, an increase in near-bank deposits or other claims changes the composition but not the total amount of chartered bank deposits. Chartered-bank deposit liabilities to the general public fall; chartered-bank deposit liabilities to trust companies, credit unions or other near-banks rise by the same amount. When the near-banks use their new funds for loans and investments, chartered-bank deposits owned by the general public rise, chartered-bank deposits owned by the near-banks fall by the same amount. However, it must be clear that in this operation, even though chartered-bank deposits remain unchanged in the aggregate, the assets held by near-banks, and the claims issued by them to the public, have risen. In other words, even at this stage there has been a relative shrinkage of the banking system, and a relative increase in that part of the community's total liquidity represented by the money-supply substitutes provided by near-banks.

**13.** The growth in near-bank assets and liabilities has exactly the same effect on the economy as a similar expansion of the banking system. However, if this is natural growth, one would expect that, in the normal competitive process, the chartered banks would show a similar rate of growth. If not, the chartered banks would have only themselves to blame. However, normal competitive conditions do not prevail because certain official regulations weigh more heavily on banks than on near-banks. For example, near-banks are subject to less strict, or non-existent, cash-reserve requirements which give them a cost advantage over the chartered banks in the market for borrowed funds—i.e. deposits. In addition, the near-banks are not required to limit their loan rates to six per cent as provided in Section 91 of the Bank Act. They may therefore handle higher-cost loans not available to the banks. This too is reflected in higher near-bank deposit rates which the banks under existing limitations are unable to match.

**14.** Over an extended period of time, the central bank will presumably allow a gradual increase in the money supply consistent with the long-run growth of the economy, but the increase in the money supply allowed will be influenced by the rate of near-bank growth. Hence artificial stimulation and abnormal expansion of money-supply substitutes will result in a smaller increase in the money supply, and a smaller rate of growth of the banking sector than would otherwise be the case. This long-run shrinkage of the banking sector relative to the system as a whole must ultimately result in a decline in the efficiency of monetary policy in performing its primary function—that of smoothing out cyclical movements in the short-run. A smaller "control base" means greater intervention for a given degree of stabilization, reflecting a corresponding decline in the efficiency of monetary policy.

**15.** In the short run, too, near-banks gain an additional advantage when the Bank

of Canada imposes "tight money" to combat a cyclical inflationary boom—or perhaps, with a fixed exchange rate, to prevent a loss of foreign-exchange reserves. At such a time, the banks are unable, under the present six per cent ceiling, to use higher interest rates in any effective way to moderate the demand for bank loans. In the meantime, the near-banks, not so restricted, can raise interest rates to attract funds and pass on these higher costs in the form of higher loan rates of interest. In other words, under these conditions, the chartered banks with their total deposits restricted by monetary policy have to restrict loans at a time when the near-banks can continue the process of loan and deposit expansion. As a result, monetary policy may have to become even more restrictive thereby further contracting the banking system—and so around again in a vicious circle. Under these conditions the growth of near-banks is literally at the expense of the chartered banks; i.e. chartered-bank deposits fall as near-bank liabilities rise.

16. What the banks lose under a restrictive monetary policy is not regained, or offset, in the recession phase of the cycle, when monetary policy is expansive. In the restrictive phase banks cannot follow the trend of rates upward; but in the expansive phase near-banks can follow rates downward. There is no need therefore for near-bank contraction relative to the banking sector in periods of easy money. In other words, the effects of restrictive and expansive monetary policies are not symmetrical over the cycle: there is a ratchet at work. Under tight money, near-banks gain, in effect, at the expense of the banks; but under easy money near-banks need not lose, and may therefore begin the next period of tight money, and near-bank expansion, in the same relative position which they had attained during the preceding tight money period.

17. Thus in both the short and the long run, monetary policy under the present limitations placed on banks tends to shrink the banking sector relative to the near-bank sector. In doing this, monetary policy becomes progressively less efficient: larger operations have to be undertaken to achieve a given effect on total liquidity in and outside the banking system. It might be argued that, in any case, the same effect is finally achieved. But the size of open-market operations required for a given effect is not a matter of indifference: there may be unpleasant side effects in the bond market. Bank of Canada open-market operations, while necessary for effective monetary policy, should be reduced to a minimum. Greater intervention by the central bank made necessary by the declining efficiency of monetary policy threatens the independence and strength of our financial markets—thereby further reducing the efficiency of Bank of Canada operations.

18. The six per cent ceiling also has a direct effect on the efficiency of monetary policy which I think is now widely recognized. When market rates of interest are high during periods of monetary restraint, the banks are unable to implement the stated or implied aims of the central bank by using the price mechanism. They can neither raise the price of bank credit to secure an efficient allocation of the scarce supply of this particular resource, nor can they increase the price of funds borrowed from the public thereby rewarding saving and penalizing spending during a period of inflation. This is a most important aspect of the allocation of financial resources. The absence of an effective price mechanism during periods of monetary restraint forces the banks to resort to the highly unpopular and necessarily arbitrary device of credit rationing. Thus the six per cent ceiling not only reduces the efficiency of monetary policy but ensures that any given effect achieved by monetary restraint will carry with it the additional burden to the economy of an uneconomic allocation of the scarce supply of credit available.

19. There are two ways, equally effective in themselves, of removing the artificial advantages or handicaps that now distort institutional growth in the financial system. We can universalize the handicaps, notably strict reserve requirements and the six per cent ceiling, that now apply only to the banks. Or we can universalize the advantages by extending to the banks the same freedom of action now available to the near-banks; i.e. we can reduce, adjust or abolish legal reserve requirements and eliminate the six per cent

ceiling on bank loan rates of interest. But, though equally effective in themselves, these alternatives are not equally desirable. If we are to achieve an efficient allocation of our financial resources, our general principle applies, and we must choose the alternative that minimizes interference with the market mechanism. The right policy is not to impose handicaps on the near-banks; but to ensure the fullest degree of competition in the market for credit by extending near-bank freedom of action to the chartered banks.

**Reserves for Near-Banks?**

**20.** However, if the financial system remains compartmentalized, if the banks are restricted to specific areas of finance, and especially if the six per cent restriction on bank lending rates remains on the statute books, then it may be necessary to resort to some universal system of reserve requirements in order to make monetary control effective. Under these conditions, ordinary market forces will be unable to operate fully to restrain the activities of all lenders. When market restraints are not permitted to operate, there is no alternative to direct controls.

**21.** Near-bank reserves are normally unaffected by open-market operations; and this would still be the case even if they took the form of clearing accounts with the Bank of Canada. It is the clientele of a near-bank, not the location of its clearing account, that determines its sensitivity to open-market operations. Therefore, to make the near-banks responsive to monetary policy through reserves, these reserves whatever their form would have to be varied upward or downward by means of variable requirements. I doubt that it would be wise to rely so heavily upon such a specific and direct control as variable reserve requirements in order to impose over-all monetary policy. Variable reserve requirements are in direct contradiction to our principle that specific controls involving direct interference with private decision-making should, where possible, be rejected or minimized in a market economy.

**22.** Therefore, as I have already indicated (paragraph 19), I hope that it will be possible to move in the other direction. I believe that the best form of monetary control works through the market. We have achieved this to a large extent in Canada: the principal control measures of the central bank over bank cash are the Bank of Canada's open-market operations; and it is through these market operations that the Bank of Canada determines the size of the banking system. I would like to see the area of market control extended. I believe it can be extended, and the efficiency of monetary policy greatly increased, if we are willing to make two important changes in the competitive environment. The first change involves the reserve requirements of the chartered banks. The second, the present six per cent ceiling on chartered bank loan rates of interest. I shall deal with them in turn.

**Reserves for Chartered Banks?**

**23.** The term "reserve" implies a source of bank liquidity and hence of safety for bank depositors. In fact, however, the higher the required cash, or other liquidity reserves, the less liquid the banking system becomes: i.e. the more of its resources are frozen in forms which cannot be availed of without breaking the law. The purpose of reserve requirements in Canada today is not the safety of depositors, which is nowhere seriously questioned, but control over the money supply. The term "reserve" has become a misnomer which, in the interest of clarity in discussion, might well be replaced by a neutral term such as "cash ratio," or "liquidity ratio" to indicate the proportion of their deposit liabilities which banks are required by law, regulation, or custom to offset with cash or low-yield assets.

**24.** Effective control of the money supply through open-market operations does not require any legal reserve whatsoever. Banks must maintain cash in the form of deposits with the Bank of Canada to meet their clearings, and the Bank of Canada, by

increasing or decreasing the banking system's working balances of cash through open-market operations, can control the total volume of chartered-bank deposits. A legal requirement of cash or other liquidity ratios above what the banks would voluntarily hold actually reduces the efficiency of monetary policy in two ways: first, it increases the amount of intervention required to bring about a given change in chartered-bank deposits; and, second (as pointed out in paragraph 14), it results in a long-run shrinkage of the banking system relative to near-banks, and hence in a reduction of that part of total liquidity under direct central-bank control. I would recommend therefore that the Commission consider either no legal cash or other liquidity ratios, or a nominal cash ratio only, which would not unduly penalize the banks. This would be in contrast to the present legal requirement of an eight per cent cash ratio and a voluntary seven per cent secondary ratio. Since, as I have suggested, neither of these is necessary to effective monetary control, the amount of the primary reserve over and above the cash required for clearing purposes is a forced indirect interest-free loan to the Government and the secondary ratio is a forced allocation of a portion of the banks' assets into specific investments. All of this is contrary to my main thesis that the best policy is the one which involves the minimum of controls and interference.

25. Balanced growth of the financial system over the long run becomes possible if we have a reasonable degree of equality between banks and near-banks in required or voluntary cash ratios. But there is still the problem of equalizing the impact of monetary policy in the short-run; and this, in the absence of special controls on near-banks (which I do not recommend), becomes largely a problem of flexible interest rates.

26. I have already pointed out that open-market operations normally do not directly affect other financial institutions. Nevertheless, these institutions do depend on getting cash in other markets—the markets for savings—in which relative interest rates play an important part in determining how a given total of savings is allocated among various financial institutions. Interest rates throughout the money market should therefore be sufficiently flexible to extend the indirect effect of open-market operations to include the near-banks. But this extension of monetary control to the near-banks through flexible interest rates depends on giving the banking system freedom to compete, especially freedom to alter interest rates as market conditions dictate. In other words, it requires a removal of the present six per cent ceiling on bank loan rates of interest. With such freedom, a restriction of bank cash would be followed by a rise in bank deposit and lending rates. Near-banks would then be unable to raise their borrowing rates in such a way as to widen any spread between chartered-bank rates and near-bank rates. The near-banks would be unable therefore to gain cash for expansion at a time when banks were being restrained. As a result, the impact of any future credit squeeze would be spread over all financial intermediaries. The impact of monetary policy would no longer be confined, as it is today, to the chartered banks alone. This would increase the efficiency of monetary policy by reducing the amount of central bank intervention necessary to attain a given policy objective.

27. I sincerely hope that the Commission will find my comments helpful in their deliberations in a range of inquiry which is of the greatest importance to the future of our country.

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